

CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1988

HEARINGS BEFORE THE COMMITTEE ON THE BUDGET UNITED STATES SENATE ONE HUNDREDTH CONGRESS FIRST SESSION

AGRICULTURE
JANUARY 21, 1987—VIEWS OF THE SECRETARY OF AGRICULTURE

CREDIT AND ASSET SALES

FEBRUARY 19, 1987

MARCH 4, 1987



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AGRICULTURE

WEDNESDAY, JANUARY 21, 1987

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Lawton Chiles (chairman of the committee) presiding.

Present: Senators Chiles, Sasser, Exon, Simon, Sanford, Conrad, Domenici, Kassebaum, Boschwitz, Grassley, Kasten, Danforth, and Nickles.

Staff present: Richard N. Brandon, staff director; and Barbara Chow, group leader for physical resources and general government.

For the minority: G. William Hoagland, staff director; and Bruce Blanton, senior analyst for agriculture.

OPENING STATEMENT OF CHAIRMAN CHILES

Chairman CHILES. Good morning, Mr. Secretary. We are pleased to have you with us today.

The 1980's have been a time of bitter harvest for American agriculture. We have spent more money in the past 6 years than in the 35 years that came before. Outlays for agricultural programs were actually higher in 1986 than the combined expenditures of the previous 4 years.

But despite all that money, agriculture is in deep trouble. Net farm income in the 1980's is 40 percent lower than it was in the 1970's. Since 1981 the accumulative losses in the farm sector will soon exceed more than a quarter of a trillion dollars. It sort of puts us in a lose/lose situation. We empty our pockets but we see our farms emptied at the same time.

We have lost over 200,000 farms since 1980, and in 1986 we registered monthly agricultural trade deficits for the first time in 15 years.

PAYMENT IN KIND PART OF PROBLEM

There is certainly a strong and growing sentiment that it is program design and management rather than a lack of funding that is troubling American agriculture. The Payment in Kind program has made Edsel and New Coke look like good investments by comparison.

Under PIK, farmers receive cash loans and they pay them back with the PIK certificates. The redemption price established by the Department is the market price rather than the loan rate, so it can

be repaid at market price. Because market price is considerably below the loan rate, the difference between the two is the loss to the Government. That seems to illustrate the problem. The Federal outlays are higher than ever, but the farm situation is as bad—or worse than it has ever been.

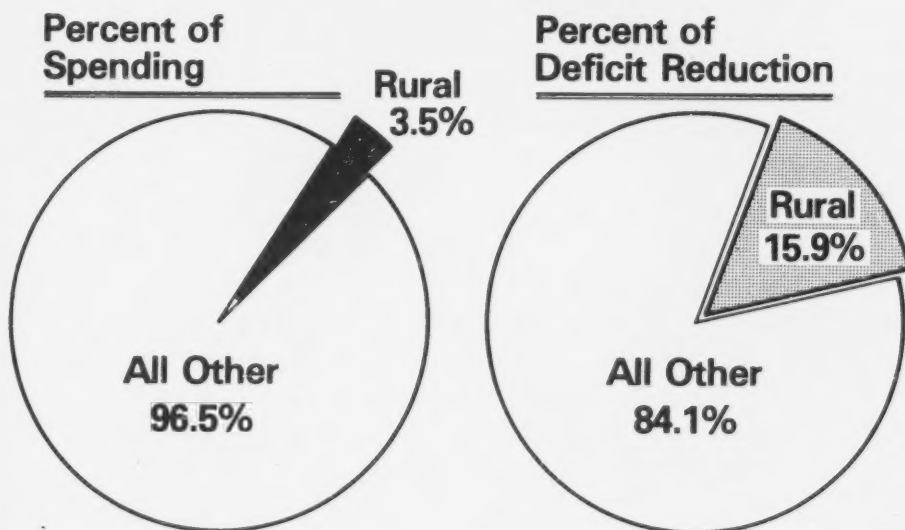
It seems that the administration now is trying to rely on the theoretical “free market” to solve our agricultural problem. Unfortunately, it is hard to find a free market in agriculture. My guess is our farmers would like nothing better than a free market to compete in. But they have got imports to contend with that are subsidized, and a whole span of pressures that make the farm economy anything but free.

PRICED OUT OF THE MARKET

We both agree that we have to give top priority to reducing the deficit. I think that huge deficit has got to be one of the principal causes for our problems to start with. That huge deficit and the interest rates that farmers had to pay have priced us out of the market. We know that we have to do something about it. But if we are going to do anything we have to have a fair program that does not place all the burden on one sector.

And that really is what this committee has been talking about; the need to get the President to call together the leaders of the House and the Senate—all of the principle players—and try to put together a fair program that would allow us to really get this deficit down.

Rural Programs Cut Disproportionately in President's Budget



When I look at your budget, I find that rural programs account for nearly 16 percent of the administration's overall budget cuts, while those same programs account for 3.5 percent of the capital outlays. And many of those proposed savings have been presented to the Congress before. If we look at this chart we see that our total percentage of spending for rural programs is 3.5 percent. That means we are spending 96.5 percent of our Federal monies on all other programs, and yet this budget would have us reduce those rural programs by 16 percent, and that seems to be awfully high.

FARM INCOME REDUCED

The budget calls for a 10-percent reduction in target prices. It sounds to me like we are trying to solve the problem by slashing farm income. Real farm income is declining while Federal cash payments are increasing as the percentage of the farms' financial profile. Again, a lose/lose situation.

The Congressional Budget Office has run some preliminary figures showing the effect of the proposed reduction in target prices on selected crops. What it amounts to is about a 25-percent reduction in farm income. Is that the solution to the agricultural problem in this country? Does that address the need that farmers have for more ready cash to save their farms? I do not think so.

We have been following a policy that depends on sales abroad to provide income at home. Those policies have driven down prices, but the export response has been disappointing. In fact, when we take a step to reduce prices, our competitors follow suit.

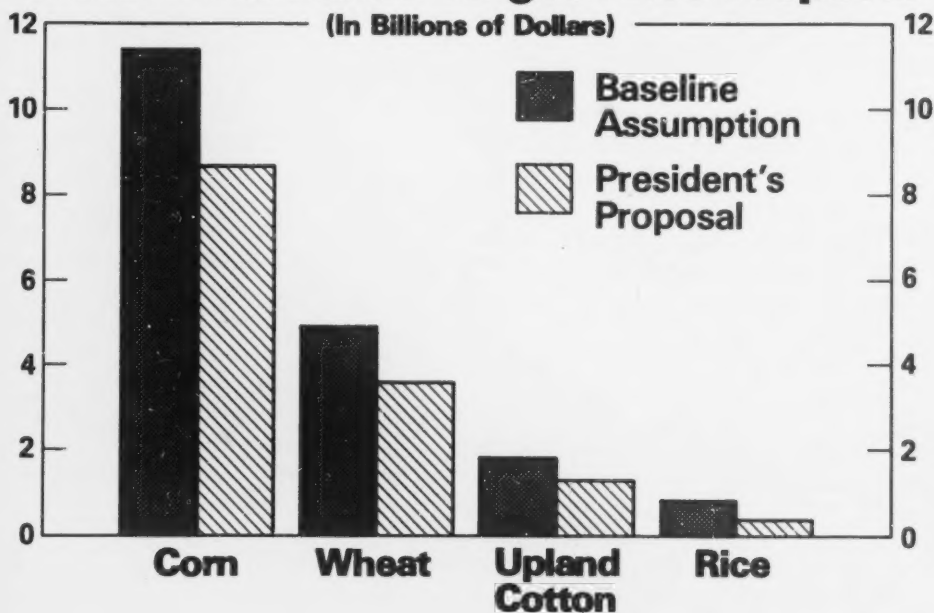
In 1984, wheat was \$154 per metric ton in both Australia and the United States. In 1985 U.S. wheat went to \$138, Australian wheat went to \$141. In November of 1986, our wheat went to \$107, Australian wheat went to \$109.

Mr. Secretary, you obviously cannot spill a bushel of grain on the ground and expect it to grow. It takes a lot of work and a lot of thought. I do not think you can spill a bushel of money on farms, either, and expect it to work. If we want to get rid of the deficit, agriculture is going to have to take some of the cuts like the rest of our programs.

I think we have a lot more work to do. We have got to take a much closer look at what the Nation gets from the farm dollar, and how fewer dollars can stretch farther. That is where we begin this morning, and we look forward to your cooperation.

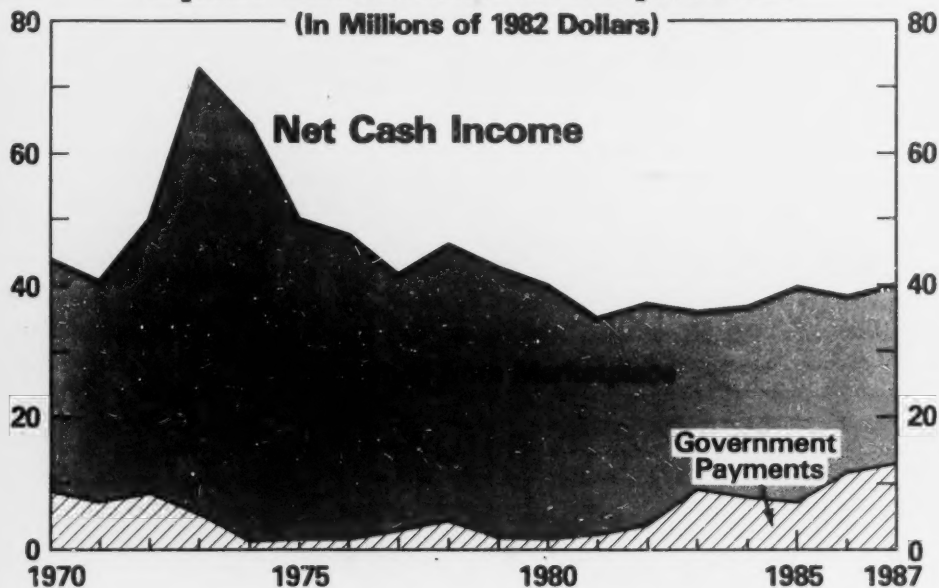
Senator Domenici.

Loss of Farm Income by 1990 Under President's Target Price Proposal



Senate Budget Committee, January 19, 1987

Farmers More Dependent Upon Government Payments



Senate Budget Committee, January 19, 1987

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Thank you very much, Mr. Chairman. I, too, welcome you, Mr. Secretary.

AGRICULTURE COMMUNITY MOST AFFECTED BY DEFICIT

As you well know, these are difficult times for farmers and citizens in rural America. Last year, we saw disappointingly low net farm income, excessive farm debt, and foreclosure problems, slumping exports, record surpluses, and record farm price support expenditures by the Federal Government.

If there is one group that has been most affected by the growing public debt, it has been the American farmer and rancher. No group is more aware of the impact of excessive deficits, the impact that it has had on their lives and their economy, than the agricultural community.

Fortunately, we have reduced interest rates, the value of the dollar, and inflation, and these things are good for agriculture. But the farmer, and rural America, is still waiting for these changes to filter down and help them. I am sure everyone agrees they are on the plus side. When results will be forthcoming remains to be seen.

We are here in this committee making pressure to reduce the deficit even further, and I am convinced that the Nation, and in particular agriculture, will greatly benefit as a result of reducing the budget deficit.

AGRICULTURAL SPENDING CANNOT BE REDUCED IN 1988

Before we get too far in this debate, I want to point out a few details about agricultural spending as it relates to the fiscal year 1988 budget, the principal one we are involved with in this committee. It needs to be clear from the outset that any farm program spending reform which causes reductions in expenditures, will not have any effect on the 1988 budget cycle.

They will not lead to significant cuts in the 1988 budget deficit. Those reductions would occur in 1989 and beyond. And, Secretary Lyng, I hope you will confirm that in your testimony today. We have already made program commitments and signed contracts for the 1987 crops. Therefore, 1988 spending on farm programs cannot be dramatically reduced.

Another point I would like to make is that the record 1986 farm program costs of about \$26 billion, by and large, did not result from farm policy changes in the 1985 farm bill. At least that is my understanding, and I would like your comments on that, Mr. Secretary.

These huge costs resulted from policies set in place, principally, in the 1981 farm bill, which drives them in substance. Costs which result from the 1985 farm bill will not be seen until the end of this year.

In recent months I have heard a lot about the need to reform the farm programs, but unfortunately, I do not see a consensus developing on how to change these farm laws. I sense a frustration here

in Congress over the hemorrhaging farm entitlement spending, but no clear plan on how to better control and direct that spending.

Perhaps the time may have come for us to do something as radical and de-entitle farm programs and place a cap on the total CCC spending. At least we would know what we are going to spend and avoid the dramatic swings in the farm cost estimates that we see each year in these budgets. Now obviously, that will not work, but I am merely suggesting that at least we would know where we are.

If we are going to reform the farm programs, I think we must be pragmatic and realistic. Farm bills take a long time to get put together, and the 1985 bill has only been in effect for a little over a year. Its impact will not even start to be seen until the end of this year at the earliest.

MORE SPENDING NOT THE SOLUTION

Mr. Secretary, I mentioned previously that last year we spent almost \$26 billion on price supports for farmers. Just 6 years earlier, in 1981, we spent about \$4 billion on the same programs. That means we spent six times more.

But Mr. Secretary, when Director Miller came before this committee I asked him if farmers were six times better off? If they were three times better off? The answer is no, and no. Many are worse off.

This tells me that a lack of spending by the Government is not the problem. More spending is certainly not the solution. In our haste to reform the farm programs, I hope that we will be careful that we do not cause more harm than good.

MANDATORY PRODUCTION CONTROLS QUESTIONED

Some are now suggesting mandatory production controls, which have recently received some additional support on both sides of the aisle. I wonder how good that would really be. As you know, there is a recent study, Mr. Secretary—and perhaps you could comment on it—by the Economic Research Service. It showed that in return for modest increases in net farm income, a mandatory production control scheme to raise farm prices to 80 percent of parity would eliminate, according to their study, 2.2 million American jobs, over 500,000 in the farm job base arena alone.

It showed that the GNP would be reduced substantially, and that the price of food would go up about 15 percent. I believe this indicates that there is a real difficult problem in coming up with a simple, plain program to solve this terrible problem of American agricultural surpluses and the dilemma of American agriculture and rural America.

There obviously are larger forces at work. The international market is changing dramatically, and it is difficult for us to comprehend and understand it all.

I look forward to your testimony and hope that we can work together in the ensuing months to do a better job for the American farmer and a better job for the budget.

Thank you, Mr. Chairman.

Chairman CHILES. Thank you, sir. Mr. Secretary.

STATEMENT OF HON. RICHARD E. LYNG, SECRETARY OF AGRICULTURE, ACCOMPANIED BY LARRY WACHS, ASSOCIATE DIRECTOR, OFFICE OF BUDGET AND PROGRAM ANALYSIS

Secretary LYNG. Thank you, Mr. Chairman, members of the committee. I am pleased to appear before you to discuss the programs of the U.S. Department of Agriculture and our fiscal year 1988 budget proposals.

REDUCING DEFICIT WILL BENEFIT AGRICULTURE

Again this year one of the most immediate problems facing the Nation is the budget deficit. The President has submitted a budget for fiscal year 1988 which meets the Gramm-Rudman deficit target of \$108 billion. In order to accomplish that it was necessary to set priorities by deciding which programs need to be maintained, because a Federal role is clearly needed, and which programs should be reduced or shifted to other funding sources. The choices were not easy ones, but they had to be made in order to get the budget under control. The Nation, and particularly agriculture, will benefit greatly as a result of reducing the budget deficit.

The Department has examined the budget from this perspective in developing its proposals for fiscal year 1988. And I might add to my prepared testimony here that you are correct, Senator Domenici, that the expenditures for 1988 cannot reflect any possible changes in farm programs, because we have already announced the 1987 programs, which have a budget impact on 1988.

It is also true that the impact of the 1985 legislation has not been fully felt in the 1986 fiscal year, but will begin to be reflected in the 1987 fiscal year.

While the President's budget reduces overall USDA program outlays for 1988 by about \$4 billion from the fiscal year 1987 current estimate, the budget maintains a high priority emphasis on a range of programs, including research, foreign market development, farm support programs, pest and disease programs, conservation and food assistance. Our budget meets the high priority needs of agriculture while at the same time being fiscally responsible.

I would like to summarize and comment briefly on some key USDA programs and how they will be affected by the 1988 budget.

COMMODITY PRICE SUPPORT PROGRAM SPENDING DOWN

Spending for commodity price support programs is projected to exceed \$21 billion in 1988. This is down from the record level of \$25.8 billion which was spent in 1986, and the near-record level which is currently estimated for 1987. The 1988 reduction occurs because advance deficiency payments for the 1987 crops shifted outlays forward from 1988 to 1987, and because a larger acreage reduction program is in effect for the 1987 corn crop which will reduce 1988 outlays. The 1985 Food Security Act, which was projected to cost just over \$50 billion for the 3 fiscal years 1986-88 when it was signed, is now estimated to cost about \$72 billion. The costs of farm programs have skyrocketed in recent years and are adding greatly to the budget deficit.

Legislation to reform farm programs as well as to control their cost will be proposed in the near future. Included among the proposals will be a reduction in statutorily mandated target prices, and the elimination of a requirement to plant a program crop in order to receive a deficiency payment. The budget reflects savings from these legislative proposals of over \$20 billion in the next 5 fiscal years.

The budget also requests urgent action to provide the Commodity Credit Corporation with a restoration of borrowing authority of \$6.6 billion so that CCC can continue to carry out its program responsibilities for the remainder of 1987. For the longer term, an increase in CCC's permanent borrowing limit from the present \$25 billion to \$40 billion is being requested so that adequate funding for the price and income support programs will be available during the next several years.

EXPANSION OF AGRICULTURAL EXPORTS HIGH PRIORITY

The expansion of U.S. agricultural exports continues among the highest priorities of this administration, and our budget proposals for fiscal year 1988 in the international area reflect our commitment to that goal. We are proposing that \$3 billion of short-term and \$500 million of intermediate-term export credit guarantees be made available during 1988. Moreover, we will be carrying out other export promotion activities during 1988, such as the Export Enhancement Program and the Targeted Export Assistance Program. We also will be funding the Foreign Agricultural Service and its market development cooperator program at the levels of recent years.

For P.L. 480 food assistance, we are proposing a program level of nearly \$1.4 billion for fiscal year 1988, which should provide for the shipment of about 7.8 million metric tons of commodities. While in dollar terms this level of programming is somewhat reduced from the level available this year, the volume of P.L. 480 food assistance will continue well above the levels of the late 1970s and the early 1980s. During 1988 additional food assistance is expected to be provided through section 416 authority, providing commodities from CCC stocks for donation overseas.

Farm operating credit will continue to be highly important to farmers during the planning season, and funding for operating credit will be maintained with more emphasis on guaranteed loans. In addition, nearly \$500 million in interest subsidies authorized by the 198S act is still available for use over the next 2 years. These funds can be used to match reductions by private lenders up to a total of 4 percentage points of the interest on farm loans. The Department will also continue to serve its borrowers with such servicing actions as subordinations, rescheduling and deferrals.

HIGH PRIORITY PLACED ON RESEARCH PROGRAMS

Our budget proposals reflect the highest priority placed on the research and extension programs of the Department. Basic research programs in the agricultural sciences would be strengthened by providing a modest level of real growth for research at our

USDA facilities, primarily in the area of plant germplasm, and by providing increases for basic formula support for the land-grant universities. Increased funding is also proposed for the highly successful competitive grants program. For the extension service, the budget includes increases for basic formula support to the traditional 1862 and 1890 institutions. Consistent with past policy, no funds are proposed for earmarked grants for research and extension.

SOIL CONSERVATION IMPORTANT TO NATION

Soil conservation is of long-term importance to the Nation, and funding of the conservation reserve program as well as conservation technical assistance at adequate levels is especially important in order to achieve soil savings on the Nation's most erosion prone land. By the end of fiscal year 1988 there will be at least 25 million acres placed under Conservation Reserve Program contracts. Costs for this program alone are estimated at over \$2 billion in 1989 and are far more than the proposed reductions in other conservation programs.

The Forest Service will offer 11.1 billion board feet in timber sales in keeping with current demand projections for our wood products. Legislation will be proposed to reform the program of receipt sharing with the States and to permit the expanded collection of recreation user fees.

The proposed budget for Domestic Food Assistance Programs would better target funds to the needy by maintaining free and reduced price meals for low-income children and Child Nutrition Programs, but discontinuing subsidies for meals served to upper income children. In Food Stamps, Federal payments to States for administrative expenses would be reduced when States issued too many benefits in error.

SOME PROGRAMS MUST BE REDUCED

In order to provide adequate funding for the priority programs I have mentioned and still lower USDA outlays for fiscal year 1988, other programs must be reduced or terminated. These include Farmers Home Administration housing and rural development programs, the Agricultural Conservation Program as well as watershed programs. There are also proposals for new or increased user fees in many areas, and for the elimination of subsidies in programs as diverse as crop insurance and for the school lunches served to nonneedy children. And, under a new initiative, lending by the Rural Electrification Administration will be shifted away from direct Government loans to a continuing program of REA guarantees of private sector loans.

REDUCE OUTLAYS THROUGH ASSET SALES

In addition to these outlay reductions, the budget will also propose that outlays for 1987 and 1988 be reduced through asset sales. As required by the Omnibus Budget Reconciliation Act of 1986, asset sales are expected to reduce net outlays for the Rural Hous-

ing Insurance Fund by \$1.7 billion and \$1 billion for the Rural Development Insurance Fund during 1987. In 1988 we are proposing asset sales which will yield \$800 million each from the housing and community loan funds. In addition, loan asset sales by the Rural Electrification and Telephone Revolving Fund and the Rural Telephone Bank will yield \$1.1 billion in fiscal year 1988.

I believe these points cover the main areas of the budget, Mr. Chairman. USDA in concert with many other Federal agencies will have to reduce outlays during 1988 if the budget deficit target is to be achieved. However, in reducing these outlays we need to insure that essential programs and services are carried out at adequate levels. I believe the budget proposals I have just outlined will accomplish these goals.

Mr. Chairman, I will be glad, of course, to respond to any questions that you may have. I am looking forward to working closely with you and members of the committee so that we can achieve our budget objectives for fiscal year 1988. Thank you.

Chairman CHILES. Thank you, Mr. Secretary.
Senator Sasser.

CONGRESS PRESENTED WITH ILLUSORY BUDGET CUTS

Senator SASSER. Thank you very much, Mr. Chairman. Mr. Secretary, I want to welcome you before the committee this morning and say that we appreciate your testimony very much. Having said that, Mr. Secretary, I continue to be concerned about what appears to me to be the inability of the administration to bring a serious budget before this committee.

I say that for this reason. We hear from the Secretaries of some Departments, such as Agriculture, about the desire to meet the Gramm-Rudman targets, and cuts in various programs are made. Yet, the Secretary of Defense comes up here before this committee and he presents a 3-percent real growth in his budget, apparently making no effort to meet the Gramm-Rudman targets.

The administration is taking the position that their budget does meet the Gramm-Rudman-Hollings deficit target of \$108 billion this year. Yet, the Senate Budget Office has just released figures that indicate that the President's deficit will be \$140 billion, so we are already more than \$30 billion over the Gramm-Rudman targets.

Now, we are continuing to be presented with illusory budget cuts that this Congress has rejected over a period of 5 years. They were rejected by the President's party, which controlled this body for the past 6 years.

DON'T CUT AT EXPENSE OF HOMELESS

Let me just give you an example of what I am talking about. There is a growing problem of homelessness in this country. It has become a national crisis, indeed, a national disgrace. Last year this Congress appropriated \$50 million to help defray the cost of food banks, soup kitchens, and other local charities, and at the urging of the Department of Agriculture it was made mandatory that State

governments would have to put up matching funds to help cover the cost of storage and distribution of surplus USDA commodities to the needy.

Well, we find that as the number of homeless and needy increase, your budget proposes to zero out funding for this commodity distribution program to the needy next year. Now, that is bad enough. But to make matters even worse, this budget before us proposes to defer nearly 60 percent of the money appropriated for this program to distribute commodities to the needy—to defer the funding in fiscal year 1987, and to transfer 60 percent of that money to other accounts to cover the 3-percent pay raise for Department of Agriculture officials.

Now, I am all in favor of those who work in the Department of Agriculture getting their 3-percent raise. I think government employees have suffered from inflation, but not at the expense of those who need these surplus commodities.

Simply stated, terminating funding for this program would force soup kitchens and other charities to choose between cutting off distribution of surplus food or reducing other services to the hungry and homeless in order to free up other resources. Now my point is this, Mr. Secretary. This is one example of the type of cuts that I think we all know this Congress is simply not going to accede to.

What is the rationale for proposing a cut in a program like this at this particular time?

Secretary LYNG. Again, I must repeat, Senator Sasser, that cuts of this kind are not the type of thing that we would prefer to do, but in setting priorities and looking at the total area of food assistance, and considering that the Federal Government is providing the surplus foods at no cost—we are delivering actually to the local communities—was felt that this was a lower priority than some of the other feeding programs, as well as, some of the other programs of the Department.

DIFFICULT TO BELIEVE SERIOUSNESS OF BUDGET

Senator SASSER. Well let's just look then, Mr. Secretary—and I say this most respectfully—let's look at the Women, Infant, and Children's feeding program. This is another feeding program, one of the most successful child nutrition programs in the history of this country. Let's just see what the Department of Agriculture said in their 5-year study on the Women, Infants, and Children program.

It concluded, "WIC improves the diets of pregnant women and children. WIC increases gestation and reduces the likelihood of pre-term delivery. WIC reduces late fetal deaths and may reduce the death rate of newborns. WIC increases the head size of infants. WIC is associated with greater likelihood of children's having a regular provider of medical care and being well vaccinated. WIC does not increase total family food expenditures."

Yet, the budget that is presented to us would take 100,000 women, infants, and children off of the WIC program. How, clearly, the Congress is not going to go along with that type of cut. And I would submit, Mr. Secretary, that our priorities are wrong when we are trying to suggest that we can reach the Gramm-Rudman deficit requirements by making those types of cuts. It's difficult for this Senator to believe that this administration is presenting a serious budget when they present these types of cuts, the same types of cuts that this Congress has rejected now over a 6-year period.

I see my time is up.

Chairman CHILES. Senator Domenici.

Senator DOMENICI. Mr. Chairman, I have been heretofore yielding to my own members, but I have to leave rather early today so I will take my 5 minutes now, and then we will proceed in the order that we came.

DIFFERENCE IN ESTIMATES

Let me, just for the record, indicate that there is a difference in the preliminary Congressional Budget Office estimates of the President's budget and the deficit that it yields versus the OMB's estimates. And Senator Chiles stated those differences yesterday publicly.

I think it is fair to say now, again, from another vantage point, where those differences principally come from. Of the \$27 billion disparity, about \$20 billion of the \$27 billion come from economic assumptions. For instance, there is a difference in the economic growth assumption that causes an \$11 billion difference on the revenue side.

So that is not a question of spending more or spending less. It is a question of which economic assumptions does this committee desire to choose in terms of guessing its best guess in 1988 on economics. And it is not a very major economic difference, it is just a difference. And it causes \$11 billion of the \$20 billion.

Three billion come from different assumptions on the farm subsidy program on what you do with advance deficiency payments; put them in the budget or leave them out. That's a clear number, over \$3 billion. That's \$14 billion, and \$6 billion is estimating the cost of medicare, one estimate versus another.

Now that—if my arithmetic is right—is \$20 billion of the difference between the two budgets. That is not, by the way, a way of saying that it is not a big, real, or difficult difference. We have to make choices as to which we are going to believe for the 1988 cycle. It does not have the blue smoke and mirrors connotation that some are placing on one budget estimate versus another. Those differences are very easily understood and within the bounds of reason.

Let me just ask you two questions that are somewhat parochial, and I will wait around, go to another hearing, come back, and then ask you some basic questions later.

REGULATIONS NOT ISSUED YET

On the very issue of homelessness, you are aware that late in the year we changed the law with reference to Food Stamps and the

homeless and the entitlement of those centers that are taking care of the homeless, who serve meals, to take food stamps for cost meals.

You were charged in that law, Mr. Secretary, with implementing the provisions so that homeless people are eligible for food stamps even if they do not have a permanent address, and to make the centers that dispense food, eligible to take food stamps for the cost of meals, if they desired.

How far along are you in implementing that law?

Secretary LYNG. Actually, I cannot specifically answer that Senator DOMENICI. I have been derelict in not pointing out that I have with me today Larry Wachs, who is the Associate Director of our Office of Budget and Program Analysis.

Larry, are you familiar with that?

Mr. WACHS. Yes, Senator. We are working on those regulations right now and expect to issue them sometime in early March.

Senator DOMENICI. Sometime in early March the regs should be issued?

Mr. WACHS. That is correct. Yes, sir.

Senator DOMENICI. One follow-up. Are you working in tandem with other Departments since this statute changed the residency requirement for a lot of different entitlement programs?

Mr. WACHS. Yes, sir. Our Food and Nutrition Service people are working with the Department of Health and Human Services people.

Senator DOMENICI. Thank you very much. Mr. Secretary, I did not expect you necessarily to know that detail, and I am delighted that your deputy understands it and has answered it here.

HUGE MOVEMENT OF CATTLE

My second one is again kind of parochial, and it will be quick. Out there in our part of the country they are very worried about the huge movement of cattle from Mexico across the border into the Southwest—Texas, New Mexico and Arizona—right in the middle of this particularly difficult season for the cattle people. From a little under 500,000 head in 1985 it seems that as many as 800,000 head were moved in January through November of 1986.

Now we know that there is an overall cap under the Meat Import Act, on how many they can move across, but Mr. Secretary, do you have any authority to handle the migration from month to month? Or is that clearly up to the Mexican market place and you only have control over the totals?

Secretary LYNG. As I understand it, we do not have a month to month system of controlling that, but there is a total annual limitation. These are mostly feeder cattle, and I believe that the population of our domestic feeder cattle have declined. I am sure those cow/calf operators would like to see the prices increase and imports from Mexico could have an adverse effect on that.

It is my understanding though, that the Mexicans while they are targeting more animals, that their actual population is not going to permit them to make a major increase in the amount over a period of a year.

Senator DOMENICI. Well Mr. Secretary, would you be willing to look into this matter with us?

Secretary LYNCH. Definitely. And I will respond, if you would like, for the record, or to you, however you wish us to do it.

Senator DOMENICI. I thank you. Thank you, Mr. Chairman.

[The following was subsequently supplied for the record by DOA:]

CATTLE IMPORTS

The Mexican Government imposes limits on the number of cattle that may enter the United States through a licensing system. Except for health considerations, the U.S. Government does not limit the number of cattle imported from Mexico, but does apply a 1¢/lb duty on each head among MFN (most favored nation) countries. In addition, cattle imports are included as part of the trigger level formula in the Meat Import Law.

Most of the cattle that enter the United States from Mexico are feeder cattle—ranging in weight from 200-700 lbs. As a general trade pattern, cattle in Mexico move northward; that is, cattle in southern Mexico move to Mexico City, and cattle in northern Mexico move to the United States. Thus, The Government of Mexico grants licenses mostly to its northern states. Licenses are issued for a September-August year. Most cattle are exported usually during the first three months of their licensing year. Supplemental licenses are issued during the remainder of the year depending on political pressures that the Mexican Cattlemen's Association can bring on their Government. In the past, cattle imports from Mexico have been rather moderate. The 1986 surge in imports from Mexico appears to be motivated by a desire to acquire U.S. dollars. Mexican cattlemen are required to deposit dollars earned from cattle sales in the Bank of Mexico and receive pesos in turn.

Cattle exports from Mexico to the United States have an historical precedent going back to the last century. Actual numbers allowed to cross the border to the United States have fluctuated over the past 16 years depending on the demand for beef in Mexico. During the period when Mexico's revenues from oil exports were high, Mexico limited the number of cattle entering the United States in order to insure sufficient beef domestically. With the decline of oil revenues, Mexico has loosened the limitations on cattle exports because of lower domestic demand and the need for foreign exchange.

For 1987, pasture conditions and cattle production appear to be good in Mexico at this time, and Mexico has allowed a large export quota of 1,070,000 head for their 1986-1987 license year. It is not believed that enough male animals exist in the Northern Mexican States at this time to meet this quota. However, exports are still expected to reach about 800,000 head for the September-August period.

U.S. IMPORTS OF CATTLE FROM MEXICO 1980-86 (1,000 HEAD)

Calendar year	Total	Feeders (200-700 lbs)
1986	1,085	1,054
1985	476	466
1984	390	389
1983	561	560
1982	509	508
1981	321	320
1980	332	328

Chairman CHILES. Thank you. Senator Exon.

Senator EXON. Thank you very much, Mr. Chairman. Mr. Secretary, welcome.

Let me first say that you know full well of the dire circumstances in rural America today, especially in agriculture, for a sub-

stantial number of our producers, and at the present time the light is not there at the end of the tunnel.

It seems to me that with the differences that we have, there is only one way out of this situation, and that is that myself and others do not agree with the significant reductions that have already been outlined here today.

I am simply suggesting that time and time again there have been suggestions made on this committee and elsewhere that we have a summit meeting with the President with regard to the fiscal problems that this Nation faces. An important part of that—probably more important a part than many realize—is the disastrous situation that is facing substantial numbers of our food producers, and I know that you know that.

AGRICULTURE SUMMIT MEETING

I am going to start out on a conciliatory note this morning and suggest that—would you be adverse to putting aside whatever recommendations this administration has made, and putting aside any of the suggested alternatives, none of which are perfect in this Senator's opinion, and could a group of us that are very much concerned about this, as I am sure that you are, approach you in some kind of a summit meeting where those of us on this committee, and others intricately involved with the agricultural legislation—could we sit down with you and some of your associates and possibly come up with some kind of a compromise plan to work our way out of the serious difficulties where costs are skyrocketing to \$26 billion—and I suspect more for agriculture in the next fiscal year?

Would you be adverse to something like that, and probably put some of our sharp differences behind us in an effort to come up with some kind of a workable solution that might not be satisfactory to us or to the administration, but some way to get a handle to do something positive and some long-range planning based on fact and not fantasy with regard to what we are going to do to protect this Nation's food plant?

Secretary LYG. Well Senator Exon, we would welcome the opportunity to meet with the group as you describe it to see if we could not come to some sort of a consensus or agreement. Senator Domenici pointed out that he did not sense a consensus in any direction toward a solution to this, so we would be pleased to do that.

It would be very difficult for me to follow your suggestion that we set aside some of the things that we are proposing. These are long-term proposals that we think definitely deserve the opportunity to be discussed openly and publicly. They involve such things as sugar legislation, which really cannot wait very much longer.

They do not involve any immediate changes in the farm programs. They would not effect the 1987 crops, so that even though we might put ourselves in a position of advocating change, it would be difficult for me to promise you that we would set those aside. But we would welcome the opportunity to have the kind of discussion that you have just described.

MUST HAVE OPEN MINDS

Senator EXON. Well I would simply say, Mr. Secretary, when I said "set aside," I did not mean necessarily that you would abandon. And that is one of the big problems. If we are going to have a summit meeting—and that is one of the problems that we have in summit meetings with the Soviet Union, they are locked into one position and we are locked into another.

I simply say to you that I do not believe that the programs that you have outlined will be accepted by the Congress and we might end up with a hodge-podge that does not solve the problem and spends additional money. I only say, though, that if we go into a summit meeting with you taking the position that you just took, that, "I will be glad to talk to you as long as you do not infringe upon the prerogatives that we have advanced," then that is not the way to go into some kind of a compromise meeting.

TRUTH IN BUDGETING

And I am very fearful that we are heading for confrontation. We are heading for confrontation on a whole series of things, Mr. Secretary. Despite what Senator Domenici has said here today, this is not a realistic budget, and he can come up with any figure that he wanted to.

I listened to Senator Domenici, and I listened to our chairman on the floor of the U.S. Senate last year, when they came up and said we were going to have a \$154 billion deficit when they knew—everyone of us on this committee and 90 percent of the U.S. Senate knew that that was a phoney figure, it was going to be about \$170 billion.

I just think that it is time for some truth in budgeting. I notice, by the way, that your statement early in your testimony said, "The President has submitted a budget for fiscal 1988 which meets the Gramm-Rudman deficit target of \$108 billion."

Now, every administration witness that has come here has had that statement, or one very similar to it, in the up-front part of their presentation.

Were you told, or was it suggested, that you put that in your opening remarks to this committee? It seems like an unbelievable coincidence that the administration people come up here and open their testimony by bragging about the fact that they have met the \$108 billion deficit reduction target of Gramm-Rudman-Hollings.

Were you told to put that in your opening remarks? Or was that just the circumstances?

Secretary LYG. No; I wasn't told, Senator Exon, to do so. But our budget supports that presented by the President, and this is a statement, as I recall, that was made early on in the President's submission to the Congress, and we—as a part of the administration—are repeating that, which in some ways helps explain the difficult priority choices we made.

Senator EXON. Well, Mr. Secretary, I would just say—and my time is up—I would just say that that is a situation of the blind leading the blind, because anybody that knows the ABCs of budgeting knows that you are about \$30 billion minimum off, just as we were \$30 to \$40 billion minimum off when we passed that phoney budget last year that quote “technically,” end quote, was described as coming into line with the Gramm-Rudman-Hollings proposal.

If we have a summit meeting—and thank you for accepting the suggestion—I think what we have to do is first be truthful as to where we are going and what we are doing. And if we are going to be bound to \$108 billion target as set by Gramm-Rudman-Hollings, then we are not going to get anywhere, we are just going to go ahead fooling ourselves and the American people that we are really significantly doing something about the budget.

I'll be back for some detailed questions at a later time. Thank you, Mr. Chairman.

Chairman CHILES. Thank you, sir. Senator Nickles.

Senator NICKLES. Mr. Chairman, thank you, and Mr. Secretary, welcome before the committee.

COST FOR AGRICULTURE PROGRAM ENORMOUS

Probably, I might ask the Chairman and ranking member—but I think of all the programs that we have had in going back to the budget process of 1981, through the farm bill, through the farm bill of 1985, the area that we have mis-guessed worse than any other area would be in agricultural programs.

And it wasn't just the 1985 program. As mentioned in your statement, we estimated that the 3-year cost of the program would be \$50 billion. Now you are saying it will be 50 percent more than that. Is that correct? Seventy-two billion dollars, or something.

So, we grossly underestimated the cost of the program. And in the 1981 program I think we made even a greater mistake. The estimates were—if my memory serves me correctly—far less than the actual cost. And so as a result we had the program going from \$4 billion to—what did you say—\$25.8 billion for 1986? That is an enormous rate of increase. That farm bill, incidentally, was written by Congress probably more than the administration, both in the 1981 and the 1985 bill.

Be that as it may, we have a farm program right now that is enormously expensive, and in this Senator's opinion, not that effective. It has helped in certain areas, there is no question. But also there is a serious question of, are we really getting our money's worth for the amount of dollars that we are pumping into the program, and are we really helping the farmers that we are trying to help?

And I note that you have several recommendations on the farm program, changes, some of which, needless to say, are going to be controversial; significant changes, particularly changes in target prices and so on.

COST OF CCC PROGRAM

I have several questions that I am going to ask, most of which—or many of which—you may not be able to answer, but I would hope that your staff would supply me with the answers.

One—and I have heard this question—when we make loans, when those loans are repaid or when that grain is sold, is that credited to the CCC account?

Secretary LYNG. Yes, it is.

Senator NICKLES. Two, would you please provide me with a cost-by-commodity for the last 6 or 7 years of the CCC program?

When we throw those commodities all together and we start talking about \$25 billion or something, I would be interested in finding out how much was wheat, corn, and others.

Secretary LYNG. Yes, we can do that.

Senator NICKLES. I would appreciate that.

Secretary LYNG. Yes. We will submit that for the record.

[The following was subsequently supplied for the record by DOA:]

COMMODITY CREDIT CORPORATION

Net Expenditures By Program, Fiscal Years 1973 through 1985 Actual

(dollars in thousands)

Item	FY 1979 Actual	FY 1980 Actual	FY 1981 Actual	FY 1982 Actual	FY 1983 Actual	FY 1984 Actual	FY 1985 Actual	FY 1985 Actual
Feed grains and products.....	\$1,143,772	\$1,205,965	-\$532,641	\$5,337,055	\$5,914,526	-\$758,330	\$5,210,307	\$12,211,471
Wheat and products.....	308,429	378,644	1,542,602	2,237,525	3,418,948	2,536,935	4,620,301	3,439,535
Rice.....	49,445	-75,759	24,016	163,515	554,379	332,995	937,555	917,024
Upland cotton.....	141,207	64,355	335,686	1,139,675	1,362,391	244,074	1,552,736	2,141,918
Tobacco.....	157,311	-57,817	-51,163	103,021	379,843	345,333	455,396	253,425
Dairy (includes FY 95 red meat purchases).....	23,770	1,011,076	1,333,933	2,132,131	2,528,123	1,502,461	2,084,695	2,337,034
Soybeans.....	3,536	116,013	95,743	169,103	237,736	-534,935	711,353	1,597,393
Peanuts.....	26,652	27,787	27,793	12,170	-6,247	1,167	12,217	32,375
Sugar.....	312,571	-405,225	-120,567	-5,443	49,359	10,233	104,309	213,607
Honey.....	-1,710	8,740	3,412	27,437	47,374	90,249	80,751	99,353
Emergency feed program.....	59,721	23,402	328,504	16,051	-134	-43	175	34
Conservation reserve program.....	--	--	--	--	--	--	--	23,146
Short-term and intermediate export credit.....	412,765	-567,459	-993,959	-323,724	57,090	-30,011	-20,444	-133,296
Export guarantee program.....	-626	-5,463	49,054	332,559	337,959	555,943	148,935	235,247
Storage facilities.....	525,038	146,365	-67,085	-193,173	-201,126	-291,831	-319,026	-223,353
Interest.....	233,427	518,034	220,253	-13,713	3,524,914	1,054,102	1,431,519	1,410,736
CCC operating expense.....	100,883	161,723	163,589	299,805	339,500	360,125	351,493	451,515
Change in working capital.....	20,752	-326,821	751,455	-135,992	-1,507,615	1,419,309	-213,933	415,715
All other.....	40,103	43,605	317,665	140,043	170,609	166,708	217,931	270,511
Subtotal, support and related.....	3,572,102	2,717,154	3,324,229	11,598,292	18,757,324	7,133,529	17,573,931	25,719,514
Special Activities (wool).....	39,421	34,529	42,079	53,955	93,575	131,959	109,365	122,539
TOTAL NET EXPENDITURES, CCC.....	3,611,523	2,751,683	4,036,307	11,652,137	19,850,902	7,315,433	17,683,196	25,341,293

Minus (-) indicates a net receipt (excess of repayments or other receipts over gross outlays of funds).

TARGET PRICE REDUCTIONS

Senator NICKLES. Your proposal calls for target price reductions of 10 percent. Is that 10 percent from compounded, or is it 10 percent from the target prices as called for in the 1985 farm bill.

Secretary LYNG. There is a reduction in the 1985 farm bill for some commodities that are spelled out.

Senator NICKLES. That is correct.

Secretary LYNG. As I understand our proposal, it will call for a reduction of a total of 10 percent for the 1988 crop, compared to the 1987 crop. However, this would be less than a 10 percent change from the current 1988 statutory level. I think for some commodities there is a 2-percent reduction which would take place under current law for the 1988 crop.

Senator NICKLES. I understand what is in the 1985 farm bill. I am looking at wheat right now, and I am trying to determine the prices. If you take the target prices that we have in the 1985 Farm Bill, which for wheat is \$4.38 in 1987, it is \$4.29 in 1988, it is \$4.16 in 1989, and it is \$4 in 1990.

Is the 10 percent off of those figures or are you taking \$4.38 minus 10—that figure minus 10, that figure minus 10, and that figure minus 10?

Secretary LYNG. It is \$4.38 minus 10 percent. The numbers compared to the ones you have given would be \$4.38 for the 1987 crop, \$3.94 for the 1988 crop, \$3.55 for the 1989, \$3.19 for 1990, and an estimated \$3.19 for the 1991 crop and thereafter.

Senator NICKLES. So the target prices for wheat would be \$4.38, \$3.94, \$3.55, and \$3.19?

Secretary LYNG. That is correct.

Senator NICKLES. Mr. Secretary, I am kind of bothered by that. Let me approach some other ideas with you and ask your Department to do some calculations on what the savings might be.

I am bothered by the target price reductions, because agriculture, as you know, is hurting. Some people are surviving, and are surviving or hanging on by those payments. The farm bill does call for a reduction in those payments. You are calling for a much more dramatic reduction.

If you look at 1990, from \$4 to \$3.19, you are looking at a significant difference. You have called for some limitations on the 50,000, which, at least this Senator is willing to look at.

I would ask you to look at some other possible changes and see what kind of savings you could make with those. One, to have all loans above a certain amount be recourse loans. Say pick a figure of \$200,000. Make all loans above that amount be recourse loans.

DEFICIENCY PAYMENTS

I have about five other questions, all of them on that side. I know you are decoupling. I want to encourage that. I think that is a good move. And I am assuming you are saying zero planning, and you would go ahead and give the deficiency payments?

Secretary LYNG. That is correct.

Senator NICKLES. Under the present law we have 50 percent and 92. Would you give a 100-percent deficiency payment with the—

Secretary LYNG. That has not been finally determined, but we were thinking of 0-92.

Senator NICKLES. 0-92?

Secretary LYNG. Instead of 50-92.

Senator NICKLES. I am interested in 0-92, 50-100, and also 0-100 in cost estimates, and then also limiting recourse loans to \$200,000 per commodity and \$200,000 per person?

My time has expired. I will return. Thank you, Mr. Chairman.

[The following was subsequently supplied for the record by DOA:]

THE 50/92 PROVISION, OTHER UNDERPLANTING OPTIONS, AND RECOURSE LOANS

The 0/92 program would make it worthwhile for some farmers not to plant any of their permitted acres. There would be no need to plant the program crop to gain deficiency payments. This program was projected in the President's budget to save about \$400 million per year because of the price support loans that would not have to be made on the additional acreage idled. This is a highly tentative estimate since we have no way of knowing how many farmers will participate in the program.

A 50/100 option would cost an average of about \$600 million per year compared to current law with the 50/92 provision. Little additional acreage would be idled, so there would be no appreciable savings on lending. Most program crops have normal underplanting in the range of 8 percent of permitted acreage or higher. The 50/100 option would pay deficiency payments on all permitted acres on farms on which at least 50 percent had been planted. The \$600 million annual cost stems from the need to make a payment on the 8 percent of the permitted acres that are excluded under current law from receiving a payment.

A 0-100 option would also have much higher deficiency payments because they would be made on the 8 percent of permitted acres currently being excluded in the 50/92 provision. However, some additional acres might remain idle because of the complete elimination of the planting requirement, and savings on net lending on these idle acres would partially offset the increase in deficiency payments. In total, the 0/100 option could raise outlays by an average of about \$300 million per year.

Limiting non-recourse loans to \$200,000 per person, with any amount above that figure becoming a recourse loan, would reduce the outlay estimates in the fiscal year 1988 President's budget between \$50 and \$125 million.

SOVIET GRAIN AGREEMENT

Chairman CHILES. Thank you, sir. Senator Simon.

Senator SIMON. Thank you, Mr. Chairman. Senator Dole—I am not sure how it came about—entered into an agreement with the Soviets for the sale of wheat, and as I understand, your Department and the State Department had some conversations, and we offered the Soviets wheat at the world spot price plus \$10 a metric ton.

And the Soviets did what I think is an understandable thing. They decided, we are not going to pay \$10 above the world market price. We are going to pay the world market price, and they bought it from France and Canada, and we lost out in that huge sale.

Do you want to explain how this happened and how we happened to lose this sale?

SOVIETS BREAK AGREEMENT

Secretary LYNG. Yes; I will be happy to do so, Senator Simon. There are some inaccuracies in the way you describe that situation.

We have a long-term agreement with the Soviet Union which calls for them to purchase a minimum quantity each year—that corresponds to our fiscal years—of corn, feed grains, and of wheat. In fiscal year 1986 the Soviets purchased that minimum and some

excess of that in corn, but they did not live up to their minimum requirements on wheat.

As a matter of fact they purchased almost no wheat in spite of the fact they had an agreement to purchase 4 million tons. The reason that they gave for their failure to live up to the agreement was that our prices were higher than the subsidized sales, that we were making to some selected countries under the Export Enhancement Program, and that we were higher priced than the European community and some other suppliers, who were subsidizing the exports to the Soviet Union. We had no subsidy at all in the pricing that they were receiving.

In order to take away that excuse, we authorized those that were offering sales—this is commercial trade—to grant a discount of \$13 a ton, which in effect did meet the world market prices. We did that, as I recall, in July and it was good until the end of September, at the end of that fiscal year.

The Soviet Union did not accept that offer. They did not buy. They have not purchased any corn or wheat, in this fiscal year. We have no understanding of their reasons.

PRICES LOWEST WITH DISCOUNT

Senator SIMON. But were you aware that they could buy from France and Canada below what we were offering to them?

Secretary LYNG. Not below the price when we offered this \$13 discount. I do not think they could on equivalent quality.

Senator SIMON. Well, is my information incorrect, that they bought from France and Canada at a lower rate?

Secretary LYNG. I do not think at the time that we were talking that they actually made very many purchases. Since that time they have been purchasing. It is very difficult for us to know exactly what price, but the European sales have generally been at lower prices than ours.

Senator SIMON. I would be interested if someone in your Department could send me the details on that.

Secretary LYNG. We will be happy to do so, but in the case of Canada, we have no hard information as to what their pricing has been.

Senator SIMON. Well, whatever information you send I would appreciate.

Secretary LYNG. We would be happy to do so.

[The following was subsequently submitted for the record by DOA:]

ADDITIONAL DETAILS ON PRICES AND SALES OF WHEAT TO THE U.S.S.R. DURING AUGUST AND SEPTEMBER, 1986

During the period when our EEP was offered to the USSR last summer, there was at the same time an unusual lull in Soviet import buying activity. It was not until very late in September, just before our offer expired, that the Soviets entered the international market. Somewhat later, we learned that organizational changes were taking place in some of the ministries in Moscow and that this probably caused some delay in usual purchasing activity.

There were two or three things that we did somewhat differently for the Soviet EEP offer than has been done in extending EEP to other wheat markets. First, we decided to use a preannounced flat level of bonus rather than use a bid system which was and still is being used everywhere else; this was done because we felt it would better fit the traditional Soviet method of purchasing in our market and

would give interested exporters the best possibility of negotiating acceptable prices with the Soviets and thus help to maximize the amount of business. The second thing that was different about the offer to the USSR was that, in determining the amount of the bonus, we took account not only of prevailing export prices from competing origins that subsidize, such as the European Community, but we also took account of the prices then being offered by other exporting countries such as Canada and Australia; this was done because, in the Soviet market, we had an entirely different situation from most of the other EEP markets where European wheat is the dominant competitor and the main price setter. Throughout our experience with the EEP, we have sought to use it mainly to compete with subsidized EC wheat and, at the same time, to minimize any disruption to the normal trading of other exporting countries. Thus, when the EEP was opened to the USSR, we felt it was important not to undercut the prices of these other exporting countries. Quite naturally, the result of this is that our bonus to the USSR was somewhat smaller than that to other EEP markets.

Initially, the announced bonus level was as set at \$13 per ton, and later, about halfway through the 2-month period of the offer, the rate was increased to \$15 per ton. At the time, some of our bonuses on sales to other EEP destinations were running in the neighborhood of \$25 per ton, but those were for soft wheat, and not for the type of wheat that the Soviets normally buy, and those were for some selected destinations where a higher bonus was needed to compete with the specialized subsidies which the Europeans give from time to time for isolated markets.

The key problem in this experience is the difficulty we have in knowing whether or to what extent the Canadian and/or Australian wheat boards might also be offering a special, discounted price to the USSR—Much like the EC frequently gives to its favorite markets in the Mediterranean or W. African area. In retrospect, since the Soviets did not take up our offer, we can only conclude that they were able to buy from Canada and Australia at very low prices. We do not know what those prices were nor even when the sales were made, and this is something we probably will not learn in the future. We do know that there was Soviet purchase of French wheat in late September, reportedly at a price of about \$75 per ton FOB. The French wheat is a soft wheat, and for the Soviet market is not exactly comparable to our wheat; nevertheless, a \$15 bonus would not have been enough to allow our exporters to compete with the EC price. The key point is that by the time all this had happened, we had gone through almost the entire 2-month period of the offer and there had not been one shred of indication of interest on the part of the buyer. Our impression at that stage was that the Soviets simply were not interested in buying U.S. wheat. There had been no real indication that, even if the rate were increased, they would buy.

The third thing that was different on this EEP initiative than on the others is that there was a 60-day time limit, whereas on the others the practice has been to make the offer effective for at least a year from the date of announcement. The reason for this difference was that the Soviets has an obligation to take U.S. wheat under a bilateral agreement. We did not wish to make the offer open-ended. We felt it was important to extend the offer to see if it would help in completing the required level of trade under the agreement, but it did not.

TARGET PRICES

Senator SIMON. I would also like to join Senator Nickles in expressing concern on the target prices. Target prices are the only program we have where we, in effect, do not subsidize farmers from other countries. The loan program does, the other programs, in effect, subsidize people in other countries.

Target prices permit our products to go out at the world market price. With corn—since we grow more corn than wheat in Illinois—as we calculate it in my office, that first year is going to mean a loss of \$370 million to farmers who are already hurting very, very badly.

And I hope that you can think hard, not only this year, but in future years—because my instinct is we will reject that cut here in Congress—to find some way other than that of reducing these figures. And I think the summit meeting Senator Exon suggested might be a good place to explore other possibilities. I also agree

with my friend, Senator Nickles, that if we reconsider the current payment cap structures, I am even willing to reduce the \$50,000 figure, as well as to put a cap on the loan program.

I think there are ways of doing it without hitting that target price. And I see that red light is on and I better stop right here, Mr. Chairman. Thank you, Mr. Secretary.

Chairman CHILES. Senator Danforth.

FARM CREDIT SYSTEM

Senator DANFORTH. Mr. Secretary, I would like to ask you about the farm credit system. There is nothing in the Administration's budget relating to any kind of emergency assistance or bailout of the Farm Credit system.

The Farm Credit system, as of the end of the third quarter in 1986, had total capital of \$6.2 billion, which was down \$2 billion from the preceding year. Losses have been running about a \$0.5 billion a quarter through 1985 and 1986. Non-accrual loans—that is, loans on which no payments are being made of interest or principal—stood at \$8 billion as of the end of September in 1986.

An article in the Kansas City Times last weekend reported that executives of the Farm Credit System said on Friday that they had new indications that their system may need massive Federal aid, sweeping reorganization, or both, in the near future.

Do you believe that the Farm Credit System is in trouble? Do you believe that it needs any infusion of capital, any kind of Federal aid? And do you believe that it needs sweeping reorganization?

Secretary LYNG. Senator, I hear all of the things you have mentioned here.

I do not, however, have any real insider knowledge or insights into what the future is going to hold for the Farm Credit System.

Ever since December 1985, the time when the Congress adopted legislation which would authorize but not appropriate rather substantial financial assistance, there has been talk of the Farm Credit System being forced to come back to the Federal Government and to get some of that money. Since that time, the reorganizations that have taken place, I think, have been of value.

We have a new Farm Credit Board, and we have some new organizations within the Farm Credit System, but it is just impossible from where I sit with no authorities in that area to be able to give a well-defined answer to your questions.

It is one of great concern to me because the Farm Credit System is one of the three major sources of credit for agricultural producers in this country. And it hurts very badly when they are in financial difficulty. But there has been this shifting of resources that we don't have access to the kind of accounting data to let me answer your question accurately.

NO FUNDS FOR FARM CREDIT SYSTEM

Senator DANFORTH. There is a widely held view in my State and, I guess, throughout the Midwest, that the Farm Credit System is in serious trouble. Obviously if it is, if it needs help, that help is going to come from the U. S. Treasury, and yet nothing has been provided by the administration in the 1988 budget.

I wonder if you could provide us with an analysis by the Agriculture Department of your view of the soundness of the Farm Credit System now, and your assessment as to how much assistance, if any, will be needed and when from the U. S. Treasury?

Secretary LYNG. We would be willing, of course, to make an effort to do that, but if I might respectfully suggest that we have the Farm Credit Board, who has the responsibility of oversight of the Farm Credit System; it is the regulator of the farm credit banks.

Senator DANFORTH. I would be happy to do it, but the Treasury ultimately will be responsible if some sort of bail-out is necessary.

My understanding is that the Department of Agriculture would be the part of our Government that would make the application to the Treasury. Am I wrong?

Secretary LYNG. I think the application would come from the Farm Credit System to the Department of the Treasury. But let me prepare a document which will give at least this information and whatever we have available.

Senator DANFORTH. Mr. Secretary, I would appreciate that.

[The following was subsequently submitted for the record by DOA:]

PURCHASE OF OBLIGATIONS

Public Law 99-205, enacted December 23, 1985, authorizes the Secretary of the Treasury to purchase obligations of the Farm Credit System Capital Corporation in such amounts as provided in advance in appropriation acts. The law requires that the Secretary consider such action upon certification by the Farm Credit Administration that (1) the Farm Credit System is in need of financial assistance to address stress of System institutions, (2) the System has committed its available capital surplus and reserves to address such financial stress, (3) the salaries and benefits of the senior executive offices of the System's institutions will be frozen during the time of such assistance and (4) further contributions of System resources, or losses incurred by the System likely will preclude the System's institutions from making credit available to eligible borrowers on reasonable terms.

A copy of any such certification must be submitted to Congress and, within 45 days, the Secretary of the Treasury must make known to the Congress and the Farm Credit Administration, the reasons and documentation for a decision on the certification.

DEPARTMENTAL BUDGET INCREASE

Senator DANFORTH. Now, let me just ask you one other question. Your budget requests a significant increase in administration, some 30-percent increase from 1987, I think, maybe more.

Could you tell us—and there is apparently no explanation of why the increased administrative costs are asked for in your budget—could you tell us what your idea is?

Secretary LYNG. Yes; I think the budget that has been submitted is still somewhat sketchy compared to what the final will be, and we will be providing more information on that.

But, as I understand it, it is because of needs in the Office of the Inspector General, the Office of the General Counsel where workloads, primarily because of the scope of these farm programs as a result of the 1985 act.

Further, I think there is a fairly considerable amount of money that is involved in our costs of hazardous waste disposal.

Senator DANFORTH. My notes indicate that you have asked for an 82-percent increase in direct administrative outlays. If you could provide us with some further justification of that increase, I would appreciate it.

Secretary LYNG. We would be happy to do that.

Senator DANFORTH. Thank you, Mr. Secretary.

Chairman CHILES. Thank you, sir.

[The following was subsequently submitted for the record by DOA:]

ADMINISTRATIVE OUTLAYS

The requested appropriation of \$40.2 million for Departmental Administration is an \$18 million increase above the FY 1987 level. This does represent a very large increase, however, of this amount, \$15.0 million is for Hazardous Waste Management as required by the Comprehensive Environmental Response, Compensation and Liability Act, \$0.1 million is for USDA's prorata share of the government-wide National Communications System, \$1.3 million is for increased pay and retirement costs, \$0.9 million is for activities previously funded by other USDA agency reimbursements (agency budgets will be offset by \$0.9 million), and the remaining \$0.7 million is for program increases.

TARGET PRICE REDUCTIONS ADDS TO DEBT CRISIS

Chairman CHILES. Mr. Secretary, according to the preliminary CBO estimates, the net cash income received by farmers for the four major commodity crops, corn, wheat, cotton and rice, would decline by 25 percent, \$4.8 billion by 1990 under your proposed target price reductions. While the effective land values on this proposal have not been estimated, they are certainly likely to be insufficient, as well.

The Economic Research Service in the USDA has recently issued a report indicating that based upon the 1985 payment levels, a 20-percent reduction in Government payments would move 4,300 farmers from a good financial position to a fair position, an additional 3,700 farmers to stress status, and 4,400 would be made vulnerable. Those figures are probably underestimated because the 1986 Government payments are much larger.

Won't your target price proposals simply exacerbate the debt crisis many farmers are facing? What is your strategy for addressing those 12,400 farmers whose debt problems are likely to become unmanageable under the President's proposed reductions?

Secretary LYNG. Well, Mr. Chairman, the assumptions that are made here are that the only change is the one in the target prices. There is a straight-lining, apparently, of markets of other prices. The target price is really the incentive for our producers to produce. The fact is that current target price levels are providing an incentive to overproduce. And then, in order to keep that somewhat within reason, we are requiring people to take sizable amounts of their acreage out of production to be eligible for the deficiency payments. I think if we would recognize that in lowering those target prices, we are reducing the cost to the Government. And I think we have to start with the assumption that we cannot continue to have programs where nearly \$26 billion of Federal funds are transferred to farm income year after year.

What we are proposing is a commencing of a reduction in target price costs in 1989 to \$17 billion, in 1990 to \$15 billion, in 1991 to

\$11 billion, and in 1992 \$10 billion. That figure, even in 1992, will be three times the amount that was the average during the Carter years. It will be over four times that of the Nixon-Ford years.

It is interesting for me to note that with all the concerns about our talking about reducing target prices, we are not really we are cutting from a very high number. Your previous chart showed a number that was extremely high.

STRATEGY TO HELP FARMERS

Chairman CHILES. Well, Mr. Secretary, what I am asking you, and what you have not answered is what are we going to do about these 12,400 farmers? You know, these are the studies of the USDA. They indicate where the switch is going to be. All of us know we cannot keep on the way that we are going. All of us know what we have done in the payment-in-kind program and other things has not helped. It has cost the Government tremendous sums of money, and it has not helped the farmers. We have more going broke.

We all know we need to wind our way out of this.

Is there some strategy, is there some help? Are we just going to say forget about them; are we going to flush them out? Your strategy seems to be that we are going to try to go to this export market. If it works, maybe we have a market. But, thus far, whatever we have done to reduce prices, we have seen other countries match us and come right down.

I do not know that we have any reason to think they are not going to come right down, again. So we are going to put our farmers out of business. We are not going to have the markets.

What I want to know right now is, is there any strategy, is there any thinking in the Department about what we do to ease the burden on these farmers moving into the vulnerable category?

Secretary LYNG. Yes, sir. We are, in fact, relying quite heavily upon the fact that we will see an improvement in export sales.

The effects of the 1985 farm bill have not been felt throughout the world. It takes a long time for producers to adjust to lower prices and countries to adjust to lower prices.

We have been competing with the treasuries of other governments. Our farmers have been asked to do that, and that is a major justification for the expenditures that we have made. We are now engaged in the multilateral trade negotiations in which, for the first time, agriculture is on center stage. And I think we have a very good opportunity to see some new trade rules adopted before these reduction would fully be in effect which will give real opportunities for our farmers to be more honestly competitive throughout the world.

TARGET REDUCTIONS SHOW NO STRATEGY

Chairman CHILES. Mr. Secretary, I am trying to listen very carefully to what you are saying. I have still not heard you say anything about any strategy to protect the farmers that we know are made vulnerable by these policies. It seems we are betting that we are going to recapture some of the export markets, and overall that is going to help. But there is no strategy, I take it to ease the

burden on the people your study shows will be the ones are made vulnerable and will be put off the farm.

Secretary LYNG. I don't know what studies you are referring to, but I don't accept the idea that this is going to put people off of the farms.

The fact is that over half the farm producers in the United States operate without direct subsidies.

Chairman CHILES. The Economic Research Service in USDA reports indicating that based upon the 1985 payment levels, a 20-percent reduction in government payments would move these people into the vulnerable category.

Secretary LYNG. If you are asking me, Mr. Chairman, do we have some other source of money to pay these farmers, we do not.

Chairman CHILES. I didn't say money. I said is there any strategy, is there any thought, is there any way to ease the burden on people that we all know are going to be put off the farm? Is there any thought of that? Is there any program?

You know, we have a program for dislocated workers. Has the administration thought of anything like that?

PROGRAM NOT DESIGNED TO HURT FARMERS

Secretary LYNG. Well, of course, farm people have taken advantage of those job retraining offers and would participate in those programs.

But the strategy is that it is not designed to lose farmers.

Chairman CHILES. Those programs are not designed for farmworkers. I don't think they have been able to take advantage of them.

Secretary LYNG. I don't think that we are contemplating the loss of as many farms as you seem to be, Mr. Chairman.

FARM CREDIT SYSTEM

Chairman CHILES. Mr. Secretary, two weeks ago, Secretary Baker indicated he thought the Farm Credit System would not require financial assistance if member banks pool their resources.

Yet, last week, Price Waterhouse's own auditor issued a qualified opinion on its financial status, and stated there is considerable uncertainty about whether or not the system could survive in its current form without external assistance.

As the chief spokesman for agriculture, what is your opinion concerning the prospects for the Farm Credit System? Have we not actually underfunded the 1987 budget by failing to include financial assistance for this contingency?

Secretary LYNG. Mr. Chairman, I honestly don't know. I don't have the kind of data that would tell me what the needs of the Farm Credit System would be.

Chairman CHILES. If you don't have it, does anybody have it, Mr. Secretary?

CREDIT SYSTEM TO RELEASE DATA

Secretary LYNG. I am not sure. I think that in a matter of a few days, there will be some information released from the Farm

Credit Administration as to what is happening to those accruals that Senator Danforth was talking about.

I think more information will become available, but perhaps the Farm Credit Board has—they are the people who audit these and supervise these banks and regulate them. But for the Department of Agriculture, we do not have that kind of accounting data.

Chairman CHILES. Well, if those reports come in and if we have to put money in, then our deficits will even be higher by having to fund them.

Secretary LYG. Well, obviously, at a time of great concern about the budget deficit, to try to find large amounts of cash would be a real problem.

Chairman CHILES. Senator Kassebaum.

Senator KASSEBAUM. Thank you, Mr. Chairman.

I really do think, Mr. Secretary, it is a great tragedy that we have done so little to look ahead and recognize the tragic change that has taken place in rural America, a dramatic change, and in our world markets as well.

I think rather than have an economic summit, as Senator Exon suggested, with the President, it would be far more valuable to have a crisis summit of the major grain-exporting nations because we are all changing in a dramatic way, and we are all overproducing and we are all subsidizing our markets. And I frankly think it would serve us well perhaps to try and do such.

I recognize that agriculture is now part of the GATT negotiations, but at best estimate they think it might be 2 years before any agreements could be reached on agriculture.

CHANGES IN PIK PROGRAM

But I would like to ask you specifically a couple of things, one being about the PIK certificates.

According to a recent CBO analysis of PIK certificates, it is estimated that the cost to the government for using such certificates to make payments to producers is greater than if the payments were really directly made in cash.

What I would like to ask you, do you have any information to dispute this statement, and have you given any thought to any changes in the PIK program?

Secretary LYG. We have, Senator Kassebaum, worked hard to try to do an honest analysis of what is the cost of PIK certificates relative to payments in cash, and the conclusion that we reach is that there is not much difference in the cost. There are some savings in the use of certificates as compared to outlays and there are some added costs.

There are some advantages, to the certificates. The use of the certificates gave us some flexibility which helped us do a number of things. One, it keeps the costs down by helping us move commodities out of storage at a time when we had need for storage.

It kept us from just accumulating commodities in government stocks which were then pretty well frozen from the markets. We think there were a number of advantages to the use of those certificates.

Now, you had a second part to the question.

Senator KASSEBAUM. Well, if you had given any thought, if the cost was higher than actual cash payments, to restructuring the program?

Secretary LYNG. Well, we have taken a look at that, and we think the advantages of continuing the program will make it very much worthwhile and if there are any costs, they are fairly cost-equal with cash payments.

PIK CERTIFICATES BEING TRADED

Senator KASSEBAUM. Well, I agree with you about the flexibility. They certainly work to the benefit of some, to a great extent, and I understand that they are now being traded on the St. Louis Board. And is that so, and that indeed the volume is spreading and growing, and that apparently the acceptability of such paper is reaching a much broader segment of society now than just farmers?

Secretary LYNG. Well, there are some people that are involved in trading them, that is true. I think that has perhaps calmed down some. The latest figures I have seem to indicate that the premiums, which existed on these, particularly during the harvest period, have diminished rather sharply and in some cases they are selling below their par value. These are not financial paper that you can keep forever. They expire.

From the reports I have had and the studies that we have made, I think that it has been an ingenious and creative and very beneficial way for us to operate.

Senator KASSEBAUM. Well, if they are being used for so many semi-speculative purposes, have you given any thought to ways to restrain that type of activity?

Secretary LYNG. We don't want them used in speculation, and if they got too high in the early stages it was because there were some special advantages where storage was short, and there were some rules that we had that generated some apparent abuses. We have now since corrected those and I don't think that is happening now.

Senator KASSEBAUM. Thank you, Mr. Secretary.

Senator DOMENICI. Mr. Chairman?

Senator KASSEBAUM. Yes, sir.

BUDGETARY COST OF PIK CERTIFICATES

Senator DOMENICI. Before you proceed, I wonder if with reference to Senator Kassebaum's inquiry and the Secretary's response, as it has to do with the actual budgetary cost of PIK certificates, I wonder if we could get a little more on the record before we wind up our hearings by asking the staff to get from CBO their best written description why they have assumed that it might be slightly more expensive, and let that be presented to the Secretary for the Department of Agriculture to respond, using their best analysis of what their views are.

Chairman CHILES. I think that would be fine.

Senator DOMENICI. And if you get that from us through CBO, would you respond in the record?

Secretary LYNG. When we are provided a copy of it to review, we would be pleased to provide you our response.

[The following was subsequently submitted for the record by DOA:]

USDA REVIEW OF CONGRESSIONAL BUDGET OFFICE CERTIFICATE REPORT

The Department has reviewed the report from the Congressional Budget Office (CBO) entitled "Budget Costs of Generic PIK Certificates." In general, we have found it to be a useful paper and believe the methodology used to estimate the potential budgetary impact of PIK certificates is a reasonable one. However, our estimates show a somewhat lower budgetary impact of certificates than the estimates calculated by CBO.

Most ideas about "recycling" of certificates into new loans involve the assumption that all bushels exchanged for certificates must re-enter the loan program if prices are to remain constant. Or, if prices fall, those bushels exchanged which do not enter the loan program must be used domestically or exported. The Department has no basic disagreement with this theory.

The magnitude of the cost increase that can be attributed to the issuance of certificates depends on the combination of increases in net loan activity and in domestic and export use which arise from the lower market prices. The CBO analytical models, as well as our own, rely heavily on assumed price elasticities which are internal to the models. The elasticities determine demand response to lower prices, indirectly government the level of surplus stocks which must enter the loan program to offset the withdrawals from CCC due to the certificates.

Price elasticity is a relationship between the change in price and the change in quantity demanded. Analysis by USDA differs from CBO's chiefly in the price impact of the certificates. While CBO finds that corn prices have been reduced by about 10 cents and wheat prices not at all, USDA analysis indicates that corn prices may have been reduced by more than that and that wheat prices would also have been reduced.

As the CBO report points out, a larger price decline from the baseline due to the use of certificates equates with a lower cost of the certificate program. This is true because the larger price decline adds more to domestic use and exports than it does to the loan stocks. In effect, we are exporting what otherwise would have gone to the loan program.

The disagreement, then, is that USDA analysts believe that the price difference between using certificates and not using certificates is greater, that total use has been increased accordingly, and that, therefore, recycling has been held to a level relatively lower than that estimated by CBO. Thus, savings in storage costs and interest are understated in the CBO analysis, as are net lending costs. All together under most conditions, USDA estimates that the net cost of issuing certificates may be neutral to a few percentage points increase in cost compared to the 14 percent budget impact that was estimated by CBO.

Finally, it should be noted that it is extremely difficult to quantify the price and outlay impacts of certificates. Analysts still do not have very much history on which to base their estimates. However, certificates have allowed the farmer and the distribution system to market hundreds of millions of bushels of grain that otherwise would have been forfeited to the CCC. Consequently, they have allowed the market to play a significant role in managing our surplus stocks and reducing this season's storage problems. It is also clear that the certificates have contributed significantly to improvements in our export and domestic use prospects and to the performance of the market.

Senator DOMENICI. Mr. Chairman, I think it is important because the Department is using them in very interesting ways, some of which appear to this Senator to be good; the flexibility appears to be an exciting tool. On the other hand, CBO seems to be saying that the ultimate cost may be more than direct cash payments, and I think we ought, before it gets too big, get some answer on this and what is the true situation.

Thank you very much.

Chairman CHILES. Thank you.

Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

GOVERNMENT'S PLAN FOR AGRICULTURE

Mr. Lyng, farmers in my State are in deep trouble, and I think you know that. That is why I am here. We have projections that we will lose half of our farmers in the next 5 years in North Dakota. That is a crisis.

I have just returned from my State. I have been at meetings where literally thousands of farmers were gathered, and the level of anxiety is as high as I have ever seen it in my State—an extraordinarily high level of anxiety.

They hear that Government programs are being cut. They hear target prices are being cut. They hear about a budget plan from the administration to cut the commitment to agriculture in half over the next 5 years.

And the question that I get repeatedly put to me that I will put to you is what is the plan? What is the plan to improve price? Because, after all, that is what farmers really want. They prefer to get the price from the marketplace. And what is the timetable for that plan? Those are the questions they are asking. These are people fighting for survival. They want to know two things.

What is the plan that is going to increase price and, number two, what is the timetable for that plan? Could you give me an answer that I could give to them?

GOVERNMENT HAS NO PLAN

Secretary LYNG. Senator Conrad, I think I would have to tell you that we would be a very foolish Department of Agriculture, it seems to me, if we made an attempt to plan ahead for agriculture with some certainty of pricing coming out of the Department.

As much as we might be criticized for not having the kind of plan that you and others have called for, it is absolutely impossible to foresee all of the things that make up the price of agricultural commodities or the cost of producing them, or the competition from other countries or the weather, and every effort that has been made for the past 50 years by the Department of Agriculture in all administrations have been just woefully weak.

Now, politically, it may sound good to say that the Department of Agriculture should have a plan that will assure profits out here at a certain point. I, for one, do not believe that we have the ability to do that.

Senator CONRAD. Let me understand because I am fairly amazed at what I have just heard.

Are you telling me there is no plan within the Agriculture Department, no strategy to increase price for American farmers?

Secretary LYNG. The strategy is to give American farmers an equal chance in exports throughout the world. And if they can remain competitive without the tariff barriers and non-tariff barriers, and without the subsidies of other governments, we think that they will be able to produce at a profit, and that is our long-term strategy.

FARMERS BEING HELD BACK

Senator CONRAD. Let me say that some of us think farmers in this country are already competitive, and we believe they are com-

petitive. We think we are being held back by larger economic policies that put us into a deep hole. When we have budget deficits, when we doubled the national debt over the last 5 or 6 years—which puts pressure on interest rates and holds the value of the dollar at unrealistic levels, it forces us out of the international marketplace. That doesn't mean farmers aren't being competitive; it points to a whole set of policies coming out of the Federal Government that put farmers in an impossible position.

And then we put it on the back of farmers and say you are not being competitive. How can it be that we were fully competitive just a few years ago and, all of a sudden, you make the assertion we are no longer competitive?

Secretary LYNG. I didn't say that we were no longer competitive, Senator.

MEETING OF AGRICULTURE NATIONS

Senator CONRAD. Let me ask this question because, again, I am disappointed that there is not what I would consider a plan to do something about price.

Is there opposition within the Department to a meeting of the major agricultural producers, to discuss a plan to bring some balance to supply and demand so that we might see a more realistic, favorable price in the marketplace?

Secretary LYNG. No; as a matter of fact, I am hosting a meeting of the five major grain exporters in San Diego at the end of February—the middle of February. That would be the Canadians, the Argentinians, the Australians, the European Community, and ourselves.

Now, this was held at the ministerial level, Cabinet level, for the first time last April in British Columbia.

There is grave difficulty, however, in getting these countries to agree on any kind of a policy. While the United States cuts our production through our acreage reduction programs, we see most of these other countries expanding their production. They have no system for reducing production such as we have. They have no ASCS offices. We have even offered to help them in designing how to do that.

Senator CONRAD. I tell you, we better not let them into our system. Our offices are closed half a day.

Secretary LYNG. The problem is what they would like to do more frequently than ever is to talk about some sort of a sharing of the world market, establishing perhaps an OPEC for wheat.

Every study we have made has indicated that that sort of thing just doesn't work. When the United States has attempted that, it has not been beneficial, and this administration will strongly be opposed to that sort of proposal.

GOAL OF MEETING

Senator CONRAD. So what is the goal of this meeting? I mean if you are going to meet but you are strongly opposed to entering into any kind of an agreement or a cooperative effort to do something about overproduction worldwide, what is the purpose of the meeting?

Secretary LYNG. One may be to discuss a subsidization policy. Another which is a major part of the GATT negotiations that are coming up, one would be to discuss existing trade barriers.

Senator CONRAD. Just let me understand.

This is not a meeting to discuss how we cooperatively might together do something about affecting the imbalance between supply and demand that is collapsing price for all of us?

Secretary LYNG. I think that we would be in favor of seeing them take some individual steps to reduce production similar to the ones that we have taken.

Senator CONRAD. Is that the purpose of this meeting?

Secretary LYNG. No; the primary purpose of the meeting is to compare information on production and marketing and sales.

Senator CONRAD. Why don't we have a meeting like that?

Secretary LYNG. We are, I am hosting it.

Senator CONRAD. No, no, no. But the meeting you are describing is not, as I understand it, for the purpose of talking about a cooperative arrangement that would try to redress the imbalance between supply and demand. That is specifically the question I asked and you said that is not the purpose.

Secretary LYNG. Well, I was wrong to have said that if I did, or I was misunderstood.

Obviously, we would like to see achievement of better balance between supply and demand.

Senator CONRAD. And will you be making a proposal at that meeting to the others on how we might do that together?

Secretary LYNG. We will be suggesting that we are, in fact, reducing our incentive to our farmers to overproduce by proposing to reduce our target prices. We would like to see them do similar things to that because for example, the intervention prices on wheat in the European Community are far higher than the world market and we would like to see them lower those.

Senator CONRAD. Well, let me just—my time has expired, but if you would, if you could provide this committee with any proposal that you are going to make at that meeting for a cooperative effort between the major producers to bring supply and demand into some greater balance so we could support a more reasonable price, I think this committee would be very, very interested in that proposal.

Secretary LYNG. Senator Conrad, we will be discussing those types of things at the meeting, but we will not have a proposal that would be as formal as that.

Senator CONRAD. Well, then we would urge you to rethink what we are going to do at that meeting and to make such a proposal.

Secretary LYNG. Well, I am certainly willing to take another look at it, but I don't think we are going to make a proposal.

Chairman CHILES. Senator Grassley.

SUPPORT FOR FARM PROGRAMS

Senator GRASSLEY. Secretary Lyng, the importance of the farm price support programs we have right now statistically in my State, if I can take a little different approach than Senator Conrad did, but right down the same line of the Census statistically saying

probably one-third of the farmers in Iowa would not be farming today if it wasn't for the price support programs we have.

And I know the administration is not proposing doing away with those programs, but any reduction in those programs along the lines of Senator Nickles' questioning or Senator Conrad's questioning obviously is going to have a direct impact upon numbers to some extent.

Now, there may be budgetary reasons for the administration's thought that there ought to be a reduction in price supports to save money. But I hope that it is not following the line that is coming from the press, that there is an urban reaction to these farm program costs. It is just not there.

And so I hope that we don't go the direction of even considering that based upon urban reaction, and supposedly urban Members of Congress coming out in support of reductions because costs are higher than anticipated.

Polls show urban people very supportive of farm programs, maybe even percentage-wise a little higher than even among farmers themselves. So I hope that you consider that.

SAVE MONEY BY TARGETING FARM PROGRAMS

Now, let's suppose, though, that there are certain things that can be done to save money, and we ought to be doing those and, hopefully, along the line of targeting the farm programs, the medium and small-sized farmers so that we aren't having a massive impact upon agriculture generally by taking people out of there.

One is to take the incentive for overproduction out of the present farm program. Another one is to make more firm the \$50,000 cap. I think there is a general agreement between you, your Department, the Congress, and OMB that things like this ought to be done.

To what extent is your 0-92 percent program geared toward accomplishing the former, and to what extent is there actual dollar savings in it? Is that 8 percent between the 92 percent and the 100 percent, or is there other savings in there that I don't see, because I think it's the 8 percent?

And then to what extent can those things be done by regulation that you can impose those right now for the 1988 crop year, and to what extent do they have to be done by law? And, particularly, cannot some changes be made in the \$50,000 cap to make it more effective, even for the 1987 crop year?

Secretary LYNG. We have some administrative authority to tighten up the definition of a person. We are working on that right now, Senator Grassley, relative to the \$50,000 limitation.

Senator GRASSLEY. For 1987?

Secretary LYNG. Well, I don't think we will be able to do it for 1987.

Senator GRASSLEY. OK.

Secretary LYNG. In simple fairness, that program has been announced for quite a long time and there are a number of farmers that are planning on the situation remaining the same.

It is my understanding that we would not propose this to be effective on the 1987 crop, but on the 1988 crop, because it will be very controversial and it may even need some assistance from the

Congress. So we think that there should be some time for suggestions and comments.

On the matter of the 0-92, we need legislation to be able to change it from 50 to zero. We think that the cost of it would be beneficial to both producers and to the government. It would be an optional program to producers..

Some farmers will save the cost of producing a crop and we will still pay them the deficiency payments, the difference between the loan or market, whichever is higher, and the target price. The difference between a 100 percent payment and 98 percent to 92 is not a major factor.

Senator GRASSLEY. This 0-92 program is part of the effort of the administration to cut \$4 billion from farm programs, though, isn't it, or am I wrong on that?

Secretary LYNG. I don't know that we have put that large a number on that proposal by itself.

Mr. WACHS. No; the number is not that large.

Senator GRASSLEY. That doesn't save money?

Secretary LYNG. It saves money, but not that much. It reduces Government stocks and will save storage, interest, and other costs. And it will be of benefit to both the farmer and the government.

Senator GRASSLEY. Let me ask you a more generic question, then.

OMB FIGURE FOR AGRICULTURE BUDGET

Last week, Secretary Bennett was here, so I am following up on a point he made to see if it is the same with the Agriculture Department.

He told this committee that he was given a mark, presumably by the White House, OMB, of a certain ceiling that there had to be in education programs.

Was there a similar mark given to you for agricultural programs to live within?

Secretary LYNG. If there was, no one passed it to me directly. We have worked with these programs with OMB in great detail. Our programs are much more varied and we have many more of them than for example, the Department of Education.

We may have perhaps got into setting marks on a program or a agency basis. Am I right, or did we have a total mark?

Mr. WACHS. No; You are correct, you are correct.

Senator GRASSLEY. You do not have a mark?

Mr. WACHS. We were not given any firm mark.

Senator GRASSLEY. OK. So then as you view what you came up with, then, it is not an arbitrary figure you had to live within, but just the evolution of what you consider good policy?

Secretary LYNG. Well, Senator, I suppose we seldom do, any of us, really agree on a budget. And some of the things that are in the President's budget we accepted because we negotiated with OMB, and perhaps I would set somewhat different priorities. Substantially, I think we can live with them, and I am not being dishonest when I say that this is a fair and honest budget. It is that kind of a problem that we have in presenting this budget.

So I don't want to give you the idea that I was able to do everything that I wanted to do with the budget, but, at the same time, I fully agree with the budget as it has been presented.

Chairman CHILES. Senator Exon.

Senator EXON. Thank you, Mr. Chairman.

Mr. Secretary, let me ask you some questions about where we are going. It has been basically the philosophy of the Reagan administration that we are going to sell our way out of these difficulties. So far, it has not worked yet, and the underlying premise with that program was that we forced down prices and then we export.

So far, that has not worked very well and I suspect that it might not work very well in the future. That is why myself and some others conducted a mini-filibuster to keep the target prices constant and frozen at the 2-year level. I am glad we did that, regardless of the cost, because without that protection, we would have considerably more pain and suffering in the farm belt than we have right now.

SUGAR SUPPORT REDUCTION

I notice that the administration's new program calls for a 12-cent-per-pound reduction in the loan rate for the sugar program with the 1988 crop. Is not that going to have a significant downward pressure on sugar prices, to the detriment of the sugar producers in this country along with the harm it will have on the corn; that is the sugar that is produced from corn? Is that a concern to you?

Secretary LYNG. This is a major problem area, Senator Exon. We will be introducing legislation which, in essence, will call for a reduction not of 12 cents but from 18 cents a pound support to 12 cents, and that will be offset to some extent by direct payments to sugarcane and sugar beet growers commencing with the 1987 crop for 5 years to help cushion the blow of that reduction in price.

Even with that, I think you are correct, it will have some adverse effect upon sugar producers in the United States. On the other hand, one of the reasons for doing it is the consumption of sugar has been dropping steadily, and we have now reached down to the point where we are only importing during this year 1 million tons of sugar, whereas just a few years ago, we were importing over 4 million tons.

And it would appear that in a very short time, we will be eliminating all imports and if we keep that support price, we will continue to see a shrinking which will begin very soon to affect our domestic producers.

Chairman CHILES. Senator Exon, I understand we still have some Senators that have not had the first round of questions.

Senator EXON. Oh, I am sorry.

Chairman CHILES. Well, I just realized that too.

Senator Kasten, and we will come back to you in just a minute.

Senator EXON. All right. Thank you.

Senator KASTEN. If the Senator would like to just conclude that one round.

Chairman CHILES. Did you finish that?

Senator EXON. No; I have got some more. I am on my second round. I am happy to yield.

Senator KASTEN. All right then. I will begin.

Mr. Chairman, thank you very much and, Mr. Secretary, welcome.

FARM PROGRAM BADLY MISGUIDED

Agriculture's crisis is a dramatic crisis, I believe, and I think that you have heard that particularly from a number of us in the Upper Midwest. We have seen dramatic changes a continuing tragedy with emphasis on continuing, and all of us know it.

In my judgment, Congress has taken greater note of that crisis than the administration has. But what we in Congress have done has still been inadequate. After years of debate, we still have commodity programs that, as has been pointed out earlier, direct the largest payments to the biggest farmers. In many cases, those are the people that are least in need of help. We still have farmers going under while the cost of farm programs goes through the roof.

Our policies toward farm credit still emphasize the needs of the minority of farmers who are borrowing from the Farmers Home Administration. I think in many cases we are ignoring the many hard-pressed borrowers from the Farm Credit System and equally important, at least in Wisconsin, from the rural banks.

PRESIDENT MUST SHOW CARE

As one who opposed the 1985 farm bill, I think we can do better on policy. But I believe that we need some help from the administration; not just you, Mr. Secretary, but also from the President.

There is a sense, and we have talked about this before in rural Wisconsin, in particular, and I think throughout the Upper Midwest, that rural America is being forgotten in Washington.

It doesn't help to point out, as we did earlier today, the increase over the Ford administration's spending or the fact that we are now spending threefold what the Carter administration did. It doesn't help that we are spending all of that money when the money obviously is not going where it is needed.

The message that the President cares, the message that the President is concerned about rural America's agony is not there; or if it is there, it is not getting through. I believe it would help a lot if the President discussed agriculture with some emphasis and some specifics; he should discuss agriculture in the state of the Union address next week, and not just a quick mention, either.

Rural America needs to hear more than just a quick mention, just a passing reference to its problems. It needs to hear what the President's administration intends to do specifically.

I would suggest, number one, what does the administration intend to do about targeting farm program benefits to the smaller farmers, and the family farmers.

Number two, what does the President intend to do about retraining farmers forced off the land to provide them with new opportunities and new jobs, and help them to make that transition?

And, number three, what, if anything, will this administration do to try to bring new industries, new opportunities, to rural areas that are hard hit by the farm crisis.

The point is that rural America needs to know that the President cares, and I hope that you will use your influence—as the President now is working through the drafts of the State of the Union Address, that you will use your influence to get that message out.

Now, we have had a number of conversations about this point. It is a matter of emphasis, and I believe that this administration has got to demonstrate the concern about the very, very real and difficult problems that all of us know are there in rural America.

THRUST OF PRESIDENT'S NEW FARM BILL

Mr. Secretary, the budget proposal that you have submitted says that legislation will be proposed later that will save roughly \$20 billion over the next 5 years. Can you tell me when we will see that legislation, particularly, and can you give us an idea of how much of that \$20 billion will come from payment limitations, how much from across-the board reductions in target prices, if that is proposed, or how much from other kinds of measures such as targeting farm benefits to those farmers that need the help?

When are we going to know where that \$20 billion is going to come from, and can you give us a rough idea today about the elements in that budget proposal for \$20 billion?

Secretary LYG. Yes; virtually all of that is going to come from the reduction in target prices. Perhaps \$19 billion would come from the target price reduction.

All of the other modifications will be relatively modest. The fact is, of course, that what we are going to propose for sugar will add costs because there is this direct payment that we do not have now.

TARGET LIMITATION ON BENEFITS

Senator KASTEN. Well, Mr. Secretary, I am disappointed in that because I think there are other kinds of changes that we are going to be working toward with you and with others in the administration, particularly with the emphasis that you are hearing from, I think, the entire committee, the emphasis toward trying to target the benefits toward the farmers that really need the help, whether we express that through or a \$50,000 limitation, a \$250,000 limitation.

You know that we came very close to a \$500,000 limitation per farmer last time. That fell through the cracks. But we have got to get a payment limitation that will allow us to target the benefits toward the farmers that really need the help.

That is, I think, an area that we could not only save some money but, more importantly, start to have a program that is more efficient and effective, geared at the people that we are trying to help.

Senator EXON [presiding]. Senator BOSCHWITZ.

SUGAR

Senator BOSCHWITZ. Thank you very much, Mr. Chairman.

I want to pursue a little bit some of the questions that my friend from North Dakota had. I heard the mention of sugar, and I suppose that Senator Conrad and I will be operating closely in those areas. But I want to pursue a little bit his line of questioning, and that is whether or not there will be a worldwide control of production and a balance of supply and demand, and whether or not that can be achieved.

Do any of the major producers now have any kind of setaside program or diversion program similar to what we have in the United States, Mr. Secretary?

Secretary LYNG. No, they don't, Senator Boschwitz, and that is the point that I was trying to make.

HIGH LOAN RATES CAUSE EXPORT PROBLEM

Senator BOSCHWITZ. And, furthermore, the increase in production that has occurred in those other countries has led to a good deal of the surplus, particularly in Europe. If you remember, all loan rates under the 1981 farm bill went up quite a bit, for example, to about \$3, \$2.75 on corn, when you increased the \$2.55 by the interest, and perhaps if you add the interest to wheat, it was \$4.50, \$4.60 even, or even a little bit more.

Did that increase—did the high loan rates increase the production figures throughout the world, in your judgment?

Secretary Lyng. Yes, Senator. As it turned out, following the passage of the 1981 farm bill, you will recall that the dollar was very strong, so that when the price that we set was translated into French francs or Argentine pesos or Canadian or Australian dollars, it became a very attractive price to those countries and they expanded production.

And in order to get rid of the surpluses, the Europeans particularly, very, very heavily subsidized their exports, and these are the problems that we have had.

Senator BOSCHWITZ. The Senator from North Dakota spoke about the fact that in a certain time period, 5 years I think he said, that there is only going to be half as many farmers in North Dakota. And I know that he was actively pursuing a plan that would raise the loan rates even higher than they are today. And I know that North Dakota is a wheat State.

ENORMOUS SET-ASIDES

Now wouldn't there have to be enormous set-asides in North Dakota, perhaps even 50 percent of the land, in the event that we were to raise the price of—or raise the loan rate to the levels at \$5, \$6?

Secretary LYNG. Yes; I hoped we learned our lesson in 1981 and following that high loan levels are not in our interest, that we have offset the reduction of the loan levels through the maintenance of the target prices and large direct payments. We would agree the results of that have been disappointing so far, but we really have not given that program enough time to work.

Senator BOSCHWITZ. I certainly agree with you, Mr. Secretary, and I would point out to my friend from North Dakota that if we do indeed raise the loan rates to very astronomical levels, that we

will probably have to lay aside half the land in his State because we won't have any export markets.

Now what would it do to the world trading picture if we had those high loan rates? Because presumptively we are either going to have a lot of wheat and corn and other goods coming into this country or we are going to establish tariff barriers around this country.

So my question Mr. Secretary is what would happen to the world trade regimen in the event that we were to establish those tariff barriers needed to protect our farmers, and an high loan rates?

Secretary LYNG. Well, if we have got them very high, it is inevitable that we would lose our export sales, and we would also encourage imports of products containing these commodities. We would find some very peculiar problems for those farmers that use grain or wheat, corn or feedgrains in their production of poultry, dairy, cattle, and swine. They would find that they were unable to compete with imported products from these countries. We would start having to build a wall around the country on other farm products.

Senator BOSCHWITZ. What would that do to the world trade regimen, Mr. Secretary?

Secretary LYNG. For agriculture it would be devastating.

Senator BOSCHWITZ. I agree.

1986 FARM CASH INCOME

Would you comment on 1986 cash farm income? How did cash farm income look in 1986?

Secretary LYNG. Net cash farm income in the United States will be the highest ever for the calendar year 1986. We will have about 30 percent, or perhaps a little more than that this year, coming from direct payments from the government, which is what we are really aiming at somewhat when we talk about reducing the target prices.

Senator BOSCHWITZ. I don't mean to make the case that the farmers are coining it out there in the rural America by any means, but it does appear to be true from the figures that I have seen that cash farm income and net farm income in 1986 was a record. I am correct in that?

Secretary LYNG. Yes, net cash farm income, at least, was the highest ever, and this year our estimates are that it will be very close to that, perhaps a bit higher.

INDUSTRY TO RURAL AMERICA

Senator BOSCHWITZ. I must also agree with Senator Kasten, who I see has left, his point about the rural enterprise zone approach in the President's speech. I hope the administration will take that approach, an approach that we talked about, Mr. Secretary, when we saw one another in Belgium, the so-called Bud Anderson approach, after the Foreign Agriculture Service Officer in England, who feel so strongly that we must do something for the rural areas to bring some industry there. And I would join Senator Kasten in hoping that the administration does something.

I am not sure, Mr. Secretary—

Senator EXON. Senator, your time has run over. Can you finish up?

ACTION UNFAIR TO SOYBEAN MARKET

Senator BOSCHWITZ. I wanted to ask one question about soybeans. The soybean program seems to be getting more expensive. The relationship, the historical relationship of about 2.3 on soybeans and corn no longer exists. It is not clear that at these prices that it should exist, but what is in the administration's plan for this year for soybeans?

Secretary LYNCH. We are taking a hard look at soybeans, and you are correct, there is a problem there because soybean growers do not have the benefits of the target prices and the deficiency payments. The lowering of the corn and the feedgrain loan levels has forced some competition into the soybean markets that is caused by government action.

There is a note of unfairness there, it seems to me.

Senator BOSCHWITZ. And another cost as well to the Federal Government. The Federal Government is now——

Secretary LYNCH. Well, that, of course, is true. If we distort the market to the point where soybean producers are forced to put their beans under loan, which is apparently going to be the case for the 1986 crop, then that adds outlays to the Federal Government.

Senator EXON. I believe we finished the first round of questions. We will begin the second round and I will take my 5 minutes.

Senator CONRAD. Mr. Chairman, if I may, Senator Boschwitz misstated my position on important elements of Federal farm policy, and I would like to correct that misimpression before we go any further, if I might.

Senator EXON. Well, I want to maintain some order, but if you feel he misrepresented your position, I will yield to you for 1 minute so you can straighten it out.

CONTROL OF COMMODITY SUPPLY AND DEMAND NEEDED

Senator CONRAD. I appreciate that, Mr. Chairman. My position on Federal farm programs, Mr. Boschwitz, is not to simply increase the loan rates willy-nilly. I think we all have enough history on this subject to know that is not going to work. So you set up a straw man and knock him down. You have not dealt with the real essence of some overall plan to improve the position of American farmers.

The reason I was pursuing the line of questioning that I was, was that to get higher loan rates, obviously you have got to deal a higher price, ultimately, which is what we are all after.

You have got to have some balance between supply and demand. And we are not going to have a reasonable price absent some balance between supply and demand. Obviously, we have got to do that on a multilateral basis.

That is why I was pursuing the questioning that I did with the Secretary, to find out if there is some plan within the administration to have a proposal. I think that is fundamental to an overall policy that is going to help agriculture.

Senator BOSCHWITZ. Well, I would say to my friend from North Dakota that there never has been an ability to get, as I indicated in my first question, other countries to join in any type of a production control. They thought it was kind of funny that the United States would try to control the production of a commodity. Our ability to do so in wheat, or corn, or other commodities is about as great as Saudi Arabia's ability to control the oil price.

And I might say to my friend that there are only 13 or 14 nations in OPEC so that the Saudis decided that they would be able to control the price, they were producing 10.5 million barrels a day, and they said, well, by withholding production, by trying to control production, and therefore we will bring demand and supply into balance, and their production went from 10.5 million to 2.5 million barrels a day. That is what I am trying to avoid for rural America.

Senator EXON. I say to my friend from North Dakota and my friend from Minnesota, if you want to carry on this discussion, please do so on your time and not mine and the rest of the committee's.

We are now going to start with the second round of questioning, and since I am chairing this I will start out and we will get on to some other subject.

I would hope, Mr. Secretary, that my earlier suggestion that maybe we have a meeting up here before you send up some legislation, if you think it is worthwhile, would possibly produce some results. As much as you seem locked in to the programs that you are going to advance here, I am quite confident that they are going to be emasculated, to use one word that describes it better than anything else.

If we could at least come over here with an administration policy that has some elements of support, other than the support that most of us would recognize from the standpoint of reducing the budget deficit, it might be worthwhile.

So if you think something like that would be helpful to you, I think it would be helpful to us. I would leave it to you to try and set that up.

EXPORT PIK PROGRAM

Let me ask you a question about Export PIK. You have used, I believe, something over \$600 million of the maximum of \$1.5 billion that the Department could have used to enhance exports in the last year. Is that a ball-park figure that is essentially correct?

Secretary LYNG. Yes; I think the figure was \$1 billion dollars.

Senator EXON. A billion and a half, I believe. You could spend, and were supposed to spend, not less than \$1 billion and not more than \$1.5 billion, according to my notes. But in any event, how much have you spent?

Secretary LYNG. We had approved roughly \$600 million of bonuses through December 1986.

Senator EXON. So you have not spent all that you could have?

Secretary LYNG. No; we plan to continue that program for the full 3 years.

Senator EXON. Do you think Export PIK, with the way it has been handled has been any significant help to the overseas market?

Secretary LYNG. Yes, Mr. Chairman. I think nearly 25 percent of our wheat exports have come from that program.

Senator EXON. Has it not caused some problems, though, Mr. Secretary, with regard to the Soviet Union and certain other nations that may have been encouraged to turn to other sources of supply, because they, as customers for a long period of time and buying substantial amounts of wheat, were somewhat taken a back by the fact that we were not giving them as good a price as we were the Soviet Union as a major customer?

Secretary LYNG. Yes; there have been some reports that there have been some offsetting adverse affects on some markets. We have, however, continued with the major markets, the Soviet Union being an exception, to maintain in Japan, and Korea, and other countries, a pretty good volume.

SOYBEANS

Senator EXON. We have had some discussion here about the soybean producers, and they are in pretty dire straights today after relying on overseas markets. They did very well at it for a long, long time.

And that has pretty well disappeared, and now beans are down, priced about where other products of the American farmer are, which is not good, at least the administration's desire to drive down prices has succeeded. But it has not moved soybeans and our other grains in the international market place as it was originally envisioned.

MARKETING LOANS

One of the remedies that are being suggested now quite widely for soybeans, and for other crops as well, is called marketing loans. Before you were Secretary of Agriculture, during the 1985 farm bill, as you know, there was a quote "arrangement" end quote, made.

I call it a deal, where the administration made a deal with some of the Southern growers of rice and cotton to go to marketing loans to get votes for the farm bill that should never have passed, in this Senator's opinion, in the first instance.

Do you believe that marketing loans are a useful thing to consider in the future, or do you think that is just another way of raiding the Treasury?

Secretary LYNG. There is no question about the effectiveness of the marketing loans for rice and cotton in terms of achieving more export sales. But this was done at great expense. It cost a lot of money to meet the world market prices on those two commodities. In cotton we have had a turn-around on that because the weather situation, particularly, has changed the supply-demand factor.

Senator EXON. Are you for marketing loans for other products, including soybeans?

Secretary LYNG. I have had the authority to do it and I have not done it. I am not in favor of them. But they would not work as well in any case, Senator.

Senator EXON. Thank you. My time is up, but who is next on this side.

Senator DOMENICI. Mr. Chairman, thank you. I have used all of my time, but I wanted to ask Senator Grassley if—Senator Grassley, have you inquired? I think everybody has inquired, have they not?

Senator Boschwitz, can you remain if I leave here shortly, for 15 minutes or so?

Senator BOSCHWITZ. Yes, I can.

FARM BANKRUPTCIES

Senator DOMENICI. I just wanted to ask the Secretary if he could, for the record, dig up in your Department and submit to us for the record, as you gather statistics about farms that are going bankrupt, and cannot make it? I assume you gather those up in at least a general way with some kind of statistics, or you can get it for us. Could you supply for the record a profile of the typical farm or farm family that is losing its land, by giving us the reasons for such bankruptcy or failure?

Can that be supplied in the record, as to whether it is principally based upon land cost or mortgage payments, or what is it that is causing it to happen? Can you dig that up and give us some kind of summary?

Secretary LYNG. Yes; we can, Senator Domenici, we can.¹

CAUSE OF BANKRUPTCIES

Senator DOMENICI. Do you have an assessment right now as to what the principal cause is at this point?

Secretary LYNG. Yes; I think that that kind of a study will clearly show that the major problem has to do with the relationship between the assets and debt. During the 1970s farmers became heavily overextended. And at the end of that period when farm prices dropped, interest rates got high, and farm land values dropped very sharply, some farmers were not able to generate enough income to carry and service the debt.

INTEREST RATES TO FARMERS HIGH

Senator DOMENICI. Now, my second question, farmers frequently say to me, and I am sure to other Senators—that while interest rates appear to be dropping in the country, and you read about the prime rate coming down, and, you know, individually you might buy a house, you know that interest rates, are falling but the interest rates on the farm are not coming down as fast as they are elsewhere. Do we have any information with reference to that, and could you supply it to us by way of regions in the country?

Secretary LYNG. Yes; I think that data is available, and I think that is correct; interest rates have not come down to farmers as much as to other people.

¹ See p. 68.

Senator DOMENICI. And I wonder if you as Secretary of Agriculture might, when you supply us with that information, if you might give us your indication as to why that is the case?

Secretary LYG. Yes; I will be happy to do that.

[The following was subsequently submitted for the record by DOA:]

SELECTED INTEREST RATES

The following table shows selected interest rates for farm and non-farm lending. The short-term prime rate for non-farm lending has fallen by about one third since 1980, while rates for short-term farm lending have declined negligibly in the same period. Long-term farm lending rates have increased on the average by over 10 percent since 1980.

Rates of the Federal Land Bank and Production Credit Association exceed rates on comparable loans from other lenders due in part to lags in adjustment of rates based on the average cost of securities financing the loan portfolio.

The decline in rates for farm loans by other lenders has also lagged behind rates for non-farm loans. Average rates on farm real estate by life insurance companies, for example, declined by about 5 percent while yields on new home mortgages declined by almost 10 percent between 1980 and 1985. The difference largely reflects overall stress in farm lending. Further, the percentage decline in farm rates between 1980 and 1985 is less than the decline in non-farm rates because farm loan rates were lower than non-farm rates at the beginning of the period.

SELECTED INTEREST RATES, 1980-85

	1980	1981	1982	1983	1984	1985	Percentage change 1980-85
Non-farm rates:							
Prime rate.....	15.27	18.87	14.46	10.79	12.04	9.94	65.1
Home mortgage yield.....	12.66	14.70	15.14	12.57	12.38	11.57	91.4
Farm long-term:							
Federal Land Banks.....	10.39	11.27	12.27	11.63	11.76	12.24	117.8
Life insurance.....	13.21	15.42	15.51	12.47	13.49	12.61	95.5
FmHA direct.....	11.05	13.00	12.94	10.79	10.75	10.75	97.3
Average.....	8.32	9.07	9.71	9.91	9.57	9.35	112.4
Farm short-term:							
Commercial banks.....	15.20	18.50	16.70	13.50	14.10	12.80	84.2
PCA.....	12.74	14.46	14.58	11.95	12.47	12.40	97.3
FmHA direct.....	11.00	14.04	13.73	10.31	10.25	10.25	93.2
Average.....	10.44	11.73	11.15	10.07	10.17	10.29	98.6

Source: New home mortgage yields (FHLBB) from 1986 Economic Report of the President. Other rates from 1987 Agricultural Finance Outlook. Average rates for short and long-term farm debt exclude farm operator household debt.

GRAMM-RUDMAN-HOLLINGS FIGURES PHONEY

Senator DOMENICI. My last observation will be one directed at the acting chairman.

Mr. Acting Chairman, you mentioned about 35 or 40 minutes ago that when the U.S. Congress passed a budget on the floor and said we had reached the Gramm-Rudman-Hollings totals—I do not remember your exact words—but nonetheless it seemed to me you were saying they were not true, it was not a true picture, it was phoney, or what did you say?

Senator EXON. Yes; I think that is what you said when you explained it on the floor.

CBO DID ESTIMATES

Senator DOMENICI. Oh, no I did not. I said that—as a matter of fact I want to say right now that for those who think CBO has just temporarily kind of expeditiously re-analyzed the President's budget—I want everyone to know that CBO was the one that did the estimates for the budget that we passed, not OMB. CBO said that budget, as implemented, meets the targets.

What I said was that there were many one-shot events in it. There were many sale-of-assets and the like that were not going to re-occur. And they didn't, and therefore we are back at it. But I really believe Congress did meet the targets. I hope we can meet them again this year, even if it—as per CBO—even it is with one-time events or whatever. I hope we can do as well meeting the \$108 billion as we did meeting the deficit reduction last year. Because I think what was done on the floor was legit.

In fact, I think I have answered the distinguished Senator from Oklahoma and put in the record where the add-ons have come from, from that point in time, and I will say, they are principally economic re-estimates, where both CBO, OMB—everyone was off. Therefore things came out differently, and the estimate of the cost of the farm programs by everyone was too low, as we did that on the Floor.

So we will have those kind of problems right along. I just did not want to leave the impression that we did not get there. We did get there. I thank the Chair.

Senator EXON. Before you leave, you may have gotten there, but I think everyone knows, and I think, Senator Domenici, you know that we are not going to end up this year with \$154 billion deficit, which was the target. And I think it was generally understood by most of the Members that voted for that, that it was an unrealistic figure.

So I guess what I am trying to bring home is that we are dealing too much, it seems to me, with unrealistic rather than honest budget figures.

Senator Conrad.

Senator CONRAD. Well, I would like to return to the note that we closed on before, because we may have some disagreement as to the Senator from North Dakota's position, but I think we are onto a question that deserves greater discussion. I am glad, Secretary Lyng, that you are here to participate.

Senator Boschwitz was questioning the effectiveness of OPEC. I would simply point out to him—and I am sure many of us recall—that when we started the process in the early 1970s we had a \$2.50 a barrel oil price and we had \$2.50 a bushel of wheat. Today the oil price is \$18 a barrel, and it has gone as high as \$39. The bushel of wheat is still \$2.50.

And some may say that OPEC has not worked. I tell you, I would like to have that same kind of failure with wheat prices that has been experienced with oil prices. Farmers would love \$18-a-bushel wheat.

FORM OPEC-LIKE GROUP FOR AGRICULTURE

But let me go further and say that in OPEC you have 14 countries—13, 14 that are participating—and they have been quite effective at dealing with price. Not fully effective, certainly, but fairly effective. And I really raise the question again, if we have got five or six major producers— if we count the EEC as one, and the Canadians, and the Australians, and the Argentineans, the United States—why is there not some merit to our attempting to achieve some producers' agreement to deal with the supply-demand imbalance?

Just because it has not been done in the past does not seem to me to be a very good reason not to try it for the future.

Secretary LYNG. Senator, I think I will just quickly summarize my answer to that and say it would not work. It simply would not work. For me to explain that would take quite a while. I will be happy to do that for you if you would like.

Senator CONRAD. Yes; I would be very interested, because I think as we look down the whole line of policy alternatives, that clearly presents itself as one. And if this is not the appropriate time, or you would feel more comfortable providing something in writing, I would be very interested in that.

Secretary LYNG. I would be happy to do so.

[The following was subsequently submitted for the record by DOA:]

WHEAT CARTEL

The United States has traditionally been opposed to the establishment of a world wheat cartel. The concept of a wheat cartel is entirely inconsistent with our grain marketing system, our philosophy on trade, our laws, and our views on encouraging the world to move towards freer trade in agriculture commodities. Market sharing would not be in the best interest of either importing or exporting countries.

An obvious out growth of a cartel arrangement would be pressures to increase wheat prices to buyers in order to maintain domestic producers returns. This would certainly dampen the growth in demand for wheat world wide and encourage wheat production in countries not participating in the cartel. Current overproduction in the major competing countries would be supported as well.

A number of factors would work against a cartel. Even if the major wheat exporters could agree on some cartel arrangement it would by no means assume world dominance since these countries account for only around a third of the world's production. Higher world prices would stimulate production in other countries. It would discourage consumption and at the same time encourage the use of other food and feed items other grains, pulses, roots and three crop oilseeds as substitutes.

In order for a cartel to work the participating countries would have to agree on equitable shares of the world wheat market. This could work as a major hurdle given the significant decline in U.S. share of the world market from around 50 percent in 1981/82 to a fourth in 1985/86. It is very unlikely that our major competitors would be willing to give up all the gains that they have enjoyed in market shares in the past 5 years.

A cartel arrangement would likely necessitate a modification in how the United States sells wheat as we are the only country among the major grain suppliers where the bulk of the wheat trade is handled by the private sector. If the cartel arrangement was to work it would likely necessitate much heavier involvement of the U.S. government in wheat selling activity.

SUGAR PRODUCTION

Senator CONRAD. All right. Let me pursue one other item in which Senator Boschwitz and I have a joint interest, and that is the matter of sugar, because the one healthy part of my State's

economy is sugar. And I think Senator Boschwitz has the same experience on his side of the border.

I noted with interest an article in the Journal of Commerce dated Wednesday, January 14, that referred to Mr. Yeutter. He said that the aim of the administration's efforts would be the eventual phasing out of sugar production in the United States.

I am interested. Is that the position of this administration? Is that the goal? Or is that a statement Mr. Yeutter made on his own?

Secretary LYNG. I think he was misquoted. I do not believe that is the goal, and I do not think that he would have said that it is the goal.

Senator CONRAD. Well, this was in the Journal of Commerce, and I would reference it to you. They even have a sub-headline. They say, "The aim of the administration's efforts would be the eventual phasing out of sugar production in the United States."

And if that is inaccurate as a statement of policy or as a statement of Mr. Yeutter's, I think it would be very, very important to get that corrected on the record. Because you can imagine the kind of shock waves that sends through an industry—and sends through a region—when they learn of an article like that. I would be happy to give you a copy.

Secretary LYNG. I have not seen or heard about that article.

PIK CERTIFICATE ABUSE

Senator CONRAD. One other question that I have involves the enormous abuse—planes flying all over North Dakota moving PIK certificates. I had a fellow yesterday tell me they were flying corporate jets from Texas to the Midwest to make the differential on PIK certificates.

I am interested, is there a study that has been done showing how the PIK certificates have been used, and some analysis of who has benefitted from the PIK certificates.

Has any study like that been done?

Secretary LYNG. I think there have been some internal studies made, but we can provide you with a paper that would give you that information. Concerning long distance PIK and roll, GAO is currently doing a study of it. Since this is the case, we have decided not do duplicate their efforts but wait and review their report when it becomes available.

Senator CONRAD. I would be very eager to have that.

[The following was subsequently submitted for the record by DOA:]

Certificates Issued and Redeemed

- Latest available data on issuance indicate that as of December 31, about \$4.6 billion certificates have been issued.
 - Largest category of purpose is deficiency payments, for which \$3.3 billion have been issued.
 - For cotton inventory protection, about \$.6 billion in cotton-specific certificates have been issued.
 - About \$.4 billion have been issued for diversion payments under the 1986-crop programs.
- As of January 21, the following redemptions have occurred:
 - Loans redeemed were \$1.8 billion, including \$.4 billion in wheat and \$1.2 billion in corn.
 - CCC inventory purchased was about \$.4 billion, including about \$123 million each of wheat and corn.
- In summary, about \$4.6 billion worth of certificates have been issued, and about \$2.2 billion worth have been redeemed, as of January 21.

National Summary of Certificate Exchanges For CCC
Inventory And Producer Loans As of 1/21/67

Commodities	CCC Inventory			Producer Loans 1/			Grand Total
	Catalogued	Non Catalogued	Total	9-Month	FOR/SPILP 2/	Total	
WHEAT							
Bushels	31,236,240	20,640,578	51,876,818	114,624,796	51,066,199	165,690,995	217,567,811
Value (\$)	75,759,918	47,112,194	122,872,112	NA	NA	392,445,085 *	515,317,197 *
CORN							
Bushels	21,431,427	52,885,007	74,316,434	745,714,656	4,750,214	750,464,870	824,781,104
Value (\$)	39,149,934	83,416,231	122,566,215	NA	NA	1,237,702,203 *	1,360,268,418 *
GR. SORGHUM							
Bushels	6,531,381	15,849,525	22,380,906	36,244,514	562,629	36,827,343	59,208,249
Value (\$)	12,791,592	27,310,016	40,101,608	NA	NA	65,986,411 *	106,088,019 *
RYE							
Bushels	1,017,754	906,740	1,924,494	1,420,144	—	1,420,144	3,344,638
Value (\$)	1,582,583	1,076,328	2,658,911	NA	NA	1,960,056 *	4,618,967 *
OATS							
Bushels	99,604	202,369	301,973	1,007,867	124,835	1,162,702	1,464,675
Value (\$)	97,419	195,049	292,468	NA	NA	1,118,404 *	1,408,872 *
BARLEY							
Bushels	15,005,311	10,761,294	25,766,605	50,572,462	2,937,142	53,509,604	79,276,209
Value (\$)	18,630,167	12,823,301	31,453,668	NA	NA	65,319,949 *	96,773,617 *
SUTHERLAND							
Bushels	33,561	449,320	482,881	2,077,379	—	2,077,379	2,560,260
Value (\$)	168,495	2,275,933	2,444,428	NA	NA	10,516,055 *	12,960,483 *
ROUGH RICE							
Oct.	21,828,270	3,160,498	24,988,768	17,657	—	17,657	25,006,425
Value (\$)	72,177,888	10,489,165	82,667,053	NA	NA	58,412 *	82,725,465 *
UPLAND COTTON							
Bales	—	—	—	3,722,109	—	3,722,109	3,722,109
Value (\$)	—	—	—	NA	—	NA	NA
HONEY							
100 Lbs.	—	—	—	1,622	—	1,622	1,622
Value (\$)	—	—	—	NA	—	NA	NA
Total Cert.							
Value (\$)	XXX	XXX	405,054,463	XXX	XXX	1,775,106,576 *	2,180,161,039 *

1/ Reflects certificate exchanges processed through date shown on report—data may be lagged 2-3 weeks. ABCH/CAD
2/ FOR = Farmer-owned reserve; SPILP = Special producer storage loan program. 28-Jan-67
NA = Not Available.

* Estimated certificate value based on the value per bushel for CCC inventory exchanged with certificates.
Total estimated certificate value does not include upland cotton or honey.

NOTE: Total of all certificates recorded through November 27: \$3.4 billion—\$2.7 generic, \$0.7 specific.

DISTRIBUTION OF FARM PROGRAM FUNDS

Senator CONRAD. One other final question, Mr. Chairman. That would be on the question of the overall program costs. When I go home farmers ask me, where does all of this money go? We are not getting it.

Is there an analysis that has been done on the \$26 billion? Or who has gotten payments under each of the programs? In other words, a full breakdown on where the \$26 billion is going?

Secretary LYG. Yes; I think we promised Senator Nickles to submit that for the record commodity by commodity. And we will do that and send you a copy of it.

Senator CONRAD. I would be very appreciative. Thank you.

[The following was subsequently submitted for the record by DOA:]

COMMODITY CREDIT CORPORATION

FY 1986 ACTUAL EXPENDITURES

(thousands of dollars)

Item	FY 1986 ACTUAL
Feed Grains and Products.....	\$12,211,471
Wheat and Products.....	3,439,686
Rice.....	947,024
Upland Cotton.....	2,141,918
Tobacco.....	253,425
Honey.....	89,358
Dairy (includes red meat purchase program).....	2,337,004
Soybeans.....	1,597,390
Peanuts.....	32,375
Sugar.....	213,607
Conservation Reserve Program.....	23,146
Export Guarantee Program.....	235,247
Short-Term & Intermediate Export Credit.....	-138,296
Storage Facility.....	-223,353
Interest.....	1,410,736
CCC Operating Expenses.....	461,516
Change in Working Capital.....	415,715
All Other.....	270,545
Subtotal, Support and Related.....	25,718,514
Wool.....	122,689
TOTAL Net Expenditures, CCC.....	25,841,203

Minus (-) indicates a net receipt (excess of repayments or other receipts over gross outlays of funds).

11/25/86

CCC FEDERAL ASSISTANCE FY 1982, 1983, 1984, 1985, AND 1986
SUMMARY BY STATE

(FILL DOLLARS)

STATE	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986
ALABAMA	\$81,161,332	\$110,060,875	\$25,408,124	\$88,071,005	\$154,429,831
ALASKA	391,793	149,712	56,378	79,977	506,251
ARIZONA	88,379,732	102,827,845	37,962,630	106,721,603	133,328,099
ARKANSAS	284,944,080	661,533,045	237,751,489	630,034,808	765,979,967
CALIFORNIA	1,133,149,139	1,068,088,048	634,071,368	1,001,776,409	1,058,084,636
COLORADO	196,599,675	397,531,991	295,632,202	450,438,904	503,300,040
CONNECTICUT	9,482,699	8,426,323	4,566,043	2,720,794	820,332
DELAWARE	4,018,559	3,082,369	1,265,861	5,831,673	14,121,155
FLORIDA	14,056,099	130,292,758	115,819,163	248,773,844	210,184,338
GEORGIA	185,035,564	170,752,050	90,124,246	223,941,872	191,301,549
HAWAII	708,354	369,655	349,435	200,666	316,565
IDAHO	153,640,102	189,923,863	155,304,926	216,680,905	264,052,970
ILLINOIS	983,555,960	1,199,570,132	200,659,632	1,049,307,475	2,832,667,830
INDIANA	388,995,400	532,987,406	121,748,990	483,675,382	1,157,763,807
IOWA	1,718,016,568	2,085,130,210	311,297,710	1,858,247,217	3,692,123,402
KANSAS	906,052,464	1,070,815,569	485,781,653	1,076,094,405	1,215,599,691
KENTUCKY	69,063,754	643,283,723	455,644,628	418,272,889	309,590,828
LOUISIANA	149,935,552	361,455,195	102,013,195	309,104,493	366,561,651

MAINE	1,475,099	1,281,928	1,725,966	2,511,044	1,690,439
MARYLAND	37,239,121	40,149,936	23,016,214	23,500,987	71,789,256
MASSACHUSETTS	8,543,053	9,310,587	3,836,414	2,828,234	1,101,852
MICHIGAN	233,995,964	291,143,681	109,606,851	278,048,873	539,313,495
MINNESOTA	1,469,239,681	1,567,453,786	721,223,795	1,614,977,660	2,381,302,837
MISSISSIPPI	284,328,801	568,851,355	252,528,643	502,477,969	614,774,390
MISSOURI	1,007,562,186	1,697,933,030	1,266,962,617	1,306,973,485	1,767,159,886
MONTANA	206,673,694	384,754,100	241,737,468	319,257,044	286,089,632
NEBRASKA	1,395,792,730	1,669,357,399	317,217,251	1,199,424,245	2,186,426,375
NEVADA	5,122,004	3,546,017	3,231,805	3,077,480	2,977,192
NEW HAMPSHIRE	1,808,328	1,321,336	795,007	1,311,089	230,621
NEW JERSEY	11,591,070	4,671,233	2,930,212	6,616,438	11,445,381
NEW MEXICO	65,141,648	69,884,683	30,172,107	85,800,376	68,122,307
NEW YORK	87,695,498	116,362,485	73,154,587	90,688,360	109,819,081
NORTH CAROLINA	492,306,719	538,654,472	249,542,958	444,568,856	424,511,805
NORTH DAKOTA	604,528,772	1,005,850,437	510,834,808	892,695,537	1,337,792,921
OHIO	240,106,484	302,871,456	83,826,603	333,017,397	726,771,015
OKLAHOMA	355,532,401	441,140,369	277,822,581	616,333,441	452,871,754
OREGON	65,790,909	66,038,092	118,115,187	138,514,654	130,448,992
PENNSYLVANIA	67,863,728	60,929,418	29,653,603	46,759,872	104,679,783
RHODE ISLAND	5,806	8,654	76,431	92,995	24,306

Chairman CHILES. Senator Nickles.

Senator NICKLES. Mr. Secretary, on that same line of thought, do you happen to have that already by States as well?

Secretary LYN. We have CCC Federal assistance totals by States. We can provide that information on a State-by-State basis.

Senator NICKLES. If you did that, I would be interested in that. It might be informative for all of us to know, and I have heard a couple of Senators already mention what it would mean in their States, and maybe it would help us get a handle on it, because we haven't, really, and that was part of my opening comments. We have made a couple of stabs in the various farm bills. We have grossly underestimated the total cost of the programs. Maybe it would help us.

ADVANCE DEFICIENCY PAYMENTS

Mr. Secretary, in your proposal you have for 1988 no advance deficiency payments. How much does that save? I have heard the figure \$3 billion.

Secretary LYN. Yes. I think it is about \$3 to \$5 billion.

Senator NICKLES. OK. Well, let me just put it like that. We have had advance deficiency payments for years, or the last several years. At our farmers' winter wheat sign-up, they receive that 40 percent. Right now you are looking at a deficiency payment of \$2.10, so you are talking about 80-something cents.

Cash flow-wise it is going to be a painful transition not to have it. I just make that statement, and I wanted to know what kind of money we are talking about so we could go from there.

MARKETING LOANS MUST BE CAPPED

You mentioned, as a response to Senator Exon's question, that you were not favorably inclined toward market loans. Let me encourage you—I have asked for several different things, and maybe I will put these in a letter so you know specifically what I am looking at—but I think there is great merit in a marketing loan for other commodities, but I think you have to have a cap. You do not have that cap with rice, and you do not have the cap with cotton.

I think you are going to have to have a cap somewhere. Have a marketing loan to where you can move those commodities, but make sure that you limit the total amount of money that you are going to spend.

In other words, if you are going to have a marketing loan where the loan rate is going to fluctuate at whatever level it takes to sell, somewhere or another those are going to have to be added, whether that cap would still be \$50,000 or whether it should be adjusted upward to some extent would be a question, I think, that we—and I say we, I am talking about the administration as well as congress—need to participate in.

But I think there is great merit to study the proposal very thoroughly of having the marketing loan with some cap. I remember when we discussed this a year ago, the same time we discussed the Export Enhancement Program, we talked about it and you said, well, it would cost too much. And it is a very expensive program. I

think we will find that when you give us the breakdown by commodity with rice and cotton.

If you put a cap or a limitation on a per farmer basis, per commodity—per farmer, per commodity, something like that—if you put that type of limitation to it, I think there is great merit to the marketing loan, and I would hope that we would consider that.

One other comment I will make, and you may or may not remember that I was a very strong advocate—I think the original proponent—of the 50-100. We eventually adopted the 50-92 proposal. One of the reasons why was to take the incentive away from over-production. I think that makes good sense.

I hear you saying that you are looking at going 0-92, or maybe a 0-100, or a 0-some figure to take away the incentive to over-production. I do not know that we have given that 50-92 program a chance to work yet.

A couple of comments. Looking at the wheat farmer, we always talked about wheat prices, and wheat prices are \$2.15 or something in my State, but a farmer participating in the program—and we have about 90-something percent of the farmers participating in my State—for the 1987 crop, if they plant on 37½, or 36.25 percent of their acres, get \$6.14, because of the 50-92 program.

Six dollars and fourteen cents per bushel of wheat for the wheat that they are producing on that 50 percent of their permitted acreage. And I think the administration or the USDA needs to let people know.

That part of the program, I think, is pretty good. Now you are talking about a zero—and I contemplated, or thought about the zero—and Senator Boren introduced one. At that time it seemed to me like, with no requirement to plant, that might be a very hard thing to sell.

TARGET PRICES

But on the plus side, I think you would be saving about 60 cents just in wheat. You would be saving about 60 cents per year in storage and handling, and that may save some real money. I do not know that you are thinking of it so much as a monetary savings, but I think it could have significant savings, particularly in a commodity like wheat where you have about 2 billion bushels in storage right now.

So maybe that is a very good idea. I told you before, I think it has a lot of merit. I would like for you to consider it. Also, I would like for you to consider the marketing loan with the type of concept of limiting the total amount of money that could be paid to anyone individual, however you wanted to define it. I think there is merit in that as well.

Chairman CHILES. Senator Grassley.

AGRICULTURE OUTLAYS LOWER THAN 1960'S

Senator GRASSLEY. Mr. Secretary, when the Secretary of Defense comes in here, he always uses the argument that because we are spending less of the gross national product on defense than we were in the 1970s or the 1960s it is a doggone good excuse for in-

creasing military appropriations. That is the argument used. I am not saying you ought to buy it.

But I wish in Cabinet meetings, if you run into that argument, you would remind OMB, and Weinberger, maybe even the President, that as far as percent of gross national product is concerned, we are not spending more on agricultural programs in the 1980s than we were in the 1970s or 1960s; in fact, probably a little bit less.

So if you look at our total resources in this country, we are not putting any more now than we were before. And hopeful it will either make them think the illegitimacy of their argument, because we are spending less on defense now GNP-wise than we were before, or else if their argument has some credibility, hopefully you can get them to see where we are on agriculture is less than we were in the 1970s and the 1960s.

FARMER JOB RETRAINING

Secondly, as a follow-up of several points brought up here by other members—the chairman was the first one to bring it up—whether or not we have got an adequate program for helping ease the pain from the farm to the non-farm. We have a program that I got through the Senate called FRED—Federal Rural Economic Development. It is a one-time reprogramming of some money for job retraining for farmers, or for farmers who want to both work off and on the farm and farm.

And that money—all last year we had problems getting it released from Mr. Clark. We re-certified that reprogramming in the budget we are in now, and so I hope that Congress has spoken twice on this, that we will get full cooperation from the Department. And maybe OMB is part of our problem here too, but it does not matter.

Congress has spoken twice on this program of setting up a revolving fund for states for the purpose of job retraining, and we would like to have the full cooperation from the administration on that.

RUSSIANS VIOLATE TRADE AGREEMENT

On another point you brought up of whether or not the Russians are keeping their agreement, my point to you—have they formally broken an agreement yet? And my point stems from the fact that back in 1982 or 1983 at one time I was in Moscow and visiting with Russian trade officials, and at that point trying to urge them to buy more from us, to reestablish trading relations the way they were, and they kept bringing up that they do not violate agreements, we violated agreements, and a perfect example of that was the Carter grain embargo.

And I think they made the point almost sweepingly that they keep their commercial agreements but we violate ours. Now, have they violated the 5-year grain agreement in a technical sense yet, or not?

Secretary LYNG. In a very real sense they have failed to buy the minimum amount of wheat that is called for in the agreement in 2 years.

Senator GRASSLEY. OK. So then they have violated——

Secretary LYNG. They have not repudiated the agreement. I am hoping that this year they live up to the agreement.

Senator GRASSLEY. No; but they have not lived up to it, though——

Secretary LYNG. They have not lived up to the agreement.

Senator GRASSLEY. For those 2 specific years. So they did violate it for those years?

Secretary LYNG. That is correct.

Senator GRASSLEY. OK. Well, I am not sure. I hope that I get a chance to talk to those same officials once again.

On another point, if you are going to have a lengthened period of time for the rollover of grain under a loan that normally can be rolled over to make room for the new crop, that is generally a 30-day rollover for feed grains.

If you are going to—and you frequently do—extend that to a period longer than 30 days—I think last year it was 60 days, and there probably was a big carryover there, we have more of a need in 1987 than 1986—do the farmers a favor and announce that early so that the farmers can take full advantage, not only of their time in August when they are not so busy before harvest in my state, but also of good marketing opportunities that they might have.

And make that very clear early on that they are going to have 60 days, so that farmers can plan. It would be very helpful.

PIK ABUSES

Another that I want to make is—on following up on whether or not we have had PIK abuses—did you not announce in December some changes of regulations, or imposition of regulations to stop some of that PIK abuse?

Secretary LYNG. Yes, we put a stop to that as soon as it was apparent to us what was happening on what would be called the long-distance PIK and roll, and then we made some changes in the differentials.

Senator GRASSLEY. Well, should that not take care of the problem that Senator Conrad——

Secretary LYNG. I think it has taken care of the problem.

Senator GRASSLEY. And I am not saying that you are wrong and that corporate jets are flying PIK certificates around, but if that is true——

Senator CONRAD. Were.

Senator GRASSLEY. Were. Well, now, is that since the December imposition of——

Senator CONRAD. No; it was before.

Senator GRASSLEY. Oh, OK.

Senator CONRAD. And what I am interested in getting is a study that shows us if there has been an analysis of where that money went.

INTERNATIONAL COMMODITY PRODUCERS AGREEMENT

Senator GRASSLEY. OK. Then, lastly, in regard to your statement that you did not think an international agreement would work, is that in regard to our attempts to get an international marketing

agreement, or is that our working with our agricultural competitors to get their own farm programs to put some limit on production like we do?

Secretary LYNG. I would be very much in favor of the kind of agreement you are talking about, and we have talked about that in Ponte del Este in Uruguay.

Senator GRASSLEY. I think that is what Senator Conrad was getting at, opposed to a marketing agreement.

Senator CONRAD. That is precisely it.

Secretary LYNG. I was trying to interpret strictly with his words, which called for a supply-demand agreement similar to OPEC.

Senator GRASSLEY. Well, let us clarify it because there may not be any difference between you and Senator Conrad on this point. Mr. Chairman, I would like to give an opportunity for clarification if there is because I think that the point that is coming from rural America now is if we have got an international problem—and, legitimately, we do—it is not toward a marketing agreement; it is toward the pressure of our government upon our competitors that maybe they ought to do the same thing we are trying to do, use taxpayers' money to reduce production. We have done it; they have not done it.

We do not care if they subsidize over-production, but we do resent their subsidizing exports, and if they have got a problem, they are going to have to look at reducing costs like we are.

Is that a fair statement of what you were urging the Secretary to do?

Senator CONRAD. What I was urging the Secretary to do is simply this: One of the problems that we have, clearly, is a tremendous imbalance between supply and demand worldwide.

If we are going to support a reasonable price in the marketplace, somehow you have to redress that imbalance. We are not going to do it alone, and it seems to me—

Senator GRASSLEY. And you want to do that through production and not through marketing?

Senator CONRAD. It seems to me that one element of a solution is that we sit down with the other producers and try to arrive at a agreement that would do something to bring some supply-demand balance back into the international marketplace. That is how you are going to get a reasonable price.

Senator GRASSLEY. From that standpoint, then, based on your response to me, you are urging other producing countries to take some steps to reduce production?

Secretary LYNG. We are, but we are not involved in getting the kind of agreement that you described when you were defending the successes of OPEC. I want to be clearly understood here that that type of thing would not work on wheat.

AGREEMENT ON REDUCING PRODUCTION NEEDED

Senator GRASSLEY. And I am not arguing for an OPEC type agreement, but I am arguing that our government needs to start working with our competitors and see that they put the same emphasis upon reducing production as we do. Otherwise, the American farmer is bearing all the brunt and all the costs, and it is cata-

strophic today, of reducing production and maybe making a minuscule impact upon world production but dramatically affecting the income and stability of farming in America.

Chairman CHILES. Senator Boschwitz.

OTHER COUNTRIES REJECT SET-ASIDES

Senator BOSCHWITZ. If I may pursue that point, I think it would be fair to say that, certainly, the European Community and others have rejected the idea of getting involved in set-asides, and they think it is rather quaint, I would say to my friend from Iowa, that if we do that, we, in effect, are helpful to them as long as we continue to do it—

Senator GRASSLEY. Can I make a point here, because your statement is absolutely right about European countries? But if you listen to the problems of farmers in Europe and the political responses, you would not know whether you were in Iowa or in Germany.

I had an opportunity to have that demonstrated to me in November when I was there. I visited both the small farms of the south of Germany and the large farms of the north of Germany.

I had opportunities to attend political rallies of the conservative party as well as the SDP, and it does not matter where you are in Germany, and for that matter all of Europe, but from the questions asked by the farmers of the politicians, the problems represented and the politicians' response—you know, it is just absolutely the same in Germany as it is in America.

Senator BOSCHWITZ. I also was in Europe, as you know, Mr. Secretary, and also visited some farms there, Senator. I am bringing one of those farmers back with me as I tour Minnesota in February, having a whole bunch of farm hearings, so that he can speak to them and talk about the Europeans' problem to them.

First, I must say, Mr. Secretary, I apologize for not being here earlier. I was at the Agriculture Committee, which was holding a meeting, and I did not mean to misstate the Senator from North Dakota's position in any way.

I would draw a distinction between agricultural commodities and OPEC, which I do not think has fared very well. I think that the market probably has reacted to production and supply and demand, but, you know, in grains only 11 percent of the world's production comes on to the market, which is not the case in oil. And every country is producing, as opposed to oil where there are just a very few producers.

And I would say to my friend from North Dakota that if you have such a conversation and if we have such a conversation, I would like to be part of it—we will get the Senator from Iowa to come over, too—to see whether or not there are some realistic ways of trying to balance supply and demand worldwide and have an impact on the price.

I am of the view that it is very, very difficult to do, and perhaps even impossible to do, but I have never heard the arguments of the Senator from North Dakota and so I look forward to doing that.

DECOUPLING

I have only one other question, and that is in decoupling. I notice that the decoupling that has been talked about in the OMB documents—but it is not clear to me exactly how it would work.

As we discussed, Mr. Secretary, I was afraid that we would not get participation by farmers in the idea of simply taking the payment and then not producing. This idea of decoupling is opposite of the idea of receiving the payment, having to produce in order to get it.

Of course, the trouble with the marketing loan is that that is an incentive to production. If you are going to pay and pay and pay, you are going to get more and more production, of course.

So the decoupling idea is of great interest to me. I do not quite understand why the Department feels—and I have not seen anything and have not read anything—why the Department feels that their plan of decoupling is going to work in this particular year, and perhaps you could describe it, Mr. Secretary, and tell me why you feel it is going to work.

SAVES COST OF STORAGE OF SURPLUSES

Secretary LYNG. Well, as has been pointed out by Senator Nickles, one of the major values of this is reducing the stocks. You would only have a program like this when it was apparent that you had huge carryovers that you are faced with.

It is already in existence to a limited extent and it is much better to not have farmers forced to produce surpluses in order to get the income from direct payments, and also to maintain their history and their base. If they do not produce, they lose that in that 5-year period that they count against what their base.

So this would permit them, as an option, to decide to produce nothing and, based on their historical production, receive the deficiency payment. It would save the government the cost of taking that much of that surplus into storage.

PAYMENT MUST BE DEFINED IN ADVANCE

Senator BOSCHWITZ. I understand, but it would be a deficiency payment. The farmer would not know at the time of planting what the payment would be, is that correct?

Secretary LYNG. Well, you mentioned that to me in a telephone conversation and I have thought about it quite a lot. It may be that we will need to define that amount some way.

But the fact is that we would not use this program if it were almost certain that there would be a deficiency payment. For example, it is clear that at the end of this corn crop year we will have probably over 5 billion bushels of corn in storage—and there is almost no scenario that you could see where we would not have deficiency payments.

Senator BOSCHWITZ. I understand. It is the extent of the deficiency payment, it is the size of the deficiency payment that will, of course, influence a farmer whether or not to decouple and not to plant in exchange for a deficiency payment.

And you are saying that because the stocks, for instance, in corn will be so high that a farmer could reasonably anticipate what the deficiency payment is going to be. Is that what you are saying?

Secretary LYNCH. Yes.

Senator BOSCHWITZ. I would remind you, Mr. Secretary, of the story that you told about coming to Washington in December 1980 and that Dr. Hjort had a study on your desk and on the desk of Bill Leshner and the Secretary of Agriculture that said the problem in the 1980s is going to be whether or not we are going to be able to produce enough for the consumption that is out there.

You know, everybody seemed to agree at that time that there was not an adequate amount of production; there was not an adequate amount of stocks. And only 2 years later, we are trying to figure out what to do with the surpluses.

I know that the Department, of which you were a part at that time, came up with the PIK program to get rid of the surpluses in December 1982. So I am very cautious about trying to project. And I think earlier in your testimony you also talked about the difficulty of projecting in these matters.

I would hope that we do move to decoupling, which I think would be a very, very wise thing. We now have programs that, as I express it, push the accelerator for production, and simultaneously push the brakes by having set-asides and diversions—with the brake padding getting a little thin. So I think we should decouple. But, if decoupling is going to work, I think that we need to define the payment to a large degree in advance. That is by way of comment rather than question.

SUGAR PRICE SUPPORT

Chairman CHILES. Mr. Secretary, I understand that you are proposing to reduce that loan rate for sugar programs to 12 cents a pound and provide a transition payment in the interim, which is going to cost \$700 million in 1988 and \$1.5 billion over the next 3 years.

That program is certainly going to have a devastating impact on farmers in my State and elsewhere, since 12 cents per pound is not a sustainable level. Why are you proposing a program that is going to cost the taxpayers and hurt our farmers at the same time when deficit reduction is such a critical problem that we face?

Secretary LYNCH. The problem, Mr. Chairman, is the declining consumption of sugar in the United States and the increasing consumption of non-sugar sweeteners, primarily high-fructose corn sweetener.

This has reduced our ability to continue to import from very significant friends of ours in countries, most of them in the Third World, to the point where we have reduced it this year from about a 1,700,000-ton quota to 1,000,000 tons. In a very short time, we will be importing no sugar and then the next phase of that will be to see our own sugar production continuing to diminish.

It was felt that faced with this that some sugar producers should be given the option and an opportunity in this transition to make a decision whether they wanted to continue at 12 cents, with some

transition period of direct income, or whether they would find it advantageous to go out of the picture.

Now, actually, it will be a controversial proposal. It already has—even though we have not formally submitted the legislation, discussions like this of it have generated some rather heated opposition particularly from sugar-producing areas, but also from corn sweetener-producing areas because they have been benefiting from the support price on sugar.

SUGAR REDUCTION TO COST TAXPAYERS

Chairman CHILES. It seems that, you know, if we look at the average, real free market price of raw sugar, in 1981 prices over the period from 1951 to 1984, we are talking about approximately 17.5 cents a pound.

I know the world price is a nickel a pound, but we know that only 20 percent of the sugar that is sold is actually sold at the world price. So if prices are roughly 17.5 cents a pound and shipping costs are over a nickel a pound how in the world can we expect that at 12 cents a pound anybody is going to be able to make it?

In order to take care of those friendly countries you talk about, we are going to pay up to \$1.5 billion and, at the same time, devastate our own producers. I do not see how that makes sense.

Secretary LYNG. Well, as I said, Mr. Chairman, it is going to be a very controversial piece of legislation. [Laughter.]

Chairman CHILES. I think I hear what you are saying, Mr. Secretary.

UNILATERAL SUGAR ACTION

Senator BOSCHWITZ. If I may ask a question, it is not clear to me, Mr. Secretary, why we would want to enter into that kind of a program without getting some kind of a response from some of our GATT negotiating partners; why we should unilaterally make a change in a program like that and not get something in return for it.

If we were getting something in return so that we could evaluate how it would affect the rural segment of our country, it would be one thing, but to just give away the sugar market is wrong. Now as the Senator from Florida indicates sugar is a small crop.

And secondly, a very small portion—I think even less than the 20 percent that he mentioned—is traded on the free market, probably very much less 20 percent. So, to just open up our shores and to devastate our sugar producers without getting any GATT response at all, I think, is folly.

Secretary LYNG. The matter of sugar will be clearly brought up in the GATT.

Senator BOSCHWITZ. I understand.

Secretary LYNG. And one of the major reasons for that very low price of sugar on the world market has been the continual subsidy of large tonnage, millions of tons of sugar, from the European Community, a huge subsidy onto the world market on almost a persistent basis.

And we have already, in preliminary discussions, talked to the Europeans about the need to do something. We have been unable to get any kind of agreement from them in bilateral discussions.

That is one of the reasons we do not have very much hope for bilateral or five-part discussions on grain production because of the policies of countries like this on sugar.

It could well be that if we could accomplish that, at the same time reducing the sugar price, that we would see the market on sugar go above that 12 cents. We would like to think that the support price on sugar would not be a factor in setting the market for sugar.

It seems to me that sugar should have a market based upon the ability of people to produce, and we had that for a number of years and it worked pretty well until the Europeans got heavily involved in excess production.

Senator BOSCHWITZ. May I say another word? I do not want to impose on the time. It is just because of the intractability of the Europeans that I think our unilateral action with respect to sugar would be very injurious to ourselves, and the probability of their reacting would not be very great.

If you could get them to react on sugar and other commodities without us unilaterally doing something, and if you were to come to us and say they are going to do this and this and this on sugar or on wheat or on corn or on beans or other things, or because of the accession of the Spaniards, if we do this in sugar, that is one thing. But to give it away in a dance, I think, is foolish.

Secretary LYN. I suspect I have done an inadequate job, Mr. Chairman, of painting the foreign policy justifications of this action, which are very important to the welfare of the United States.

Chairman CHILES. Senator Conrad.

PHASING OUT SUGAR PRODUCTION

Senator CONRAD. There are serious considerations for our domestic producers as well. Again, I hope very much that the Journal of Commerce is wrong; that it is not the desire of the administration to phase this country out of sugar production because I think that would be a bad mistake for our domestic economy, notwithstanding the foreign relations considerations.

MEETING PROPOSED TO REDUCE PRODUCTION

But let me go back to the question for a moment of the notion of a plan to do something about price, whether by reducing supply or increasing demand. Are you familiar with a proposal that the French agriculture commissioner made about a month ago when he was in the United States, much along the lines of what I have been talking about here today?

Secretary LYN. Yes. I hosted a luncheon for the minister. I know the minister quite well.

Senator CONRAD. And he, as I understand it, proposed that we have a meeting, a summit meeting of the major producers to discuss ways of bringing some balance between supply and demand.

Several members of the Canadian Parliament have come to meet with me and have said that they would be interested in pursuing a meeting like that. They tell me they think the Australians would also be interested.

Is it the position of the administration that it is just beyond consideration and there is just no thought at all of making the attempt, at least, to have those discussions?

Secretary LYNG. The kind of proposal that was made by the French minister, we believe will simply not work. We have indicated a willingness to meet with him and talk to him whenever. He does not speak for the European Community. He speaks for one of the 12 countries, the major producer in the European Community.

But in negotiations of this kind, the vice president of the Commission, the Commissioner for Agriculture, Franse Andriessen, will lead their delegation. And we will have the minister from Canada, the minister from Australia, the minister from Argentina, and myself at this meeting, which we hope to have at least annually.

We have had them annually with sub-cabinet or staff level for years.

Senator CONRAD. But it is not on the agenda of that meeting to have the kind of discussion that I have talked about here today? I want to make very sure I am clear on this because I do not want to misrepresent your position.

I mean, at that meeting is there going to be an agenda item that discusses a plan, a proposal, or any kind of an effort by the major producers to do something about the imbalance between supply and demand?

Secretary LYNG. I would guess that we will discuss that. The agenda will not call for it specifically. The thing we will not, the United States, seriously discuss is any kind of market sharing or price fixing.

WORLD SUGAR PRICE WITHOUT SUBSIDY

Senator CONRAD. One final question, Mr. Chairman, and that is on the question of sugar. If there were no subsidy by the Europeans, do we have a study that indicates what the world market price would be?

Secretary LYNG. I do not know whether we do.

Senator CONRAD. It has been asserted to me that it would be 20 cents. There is a study that has been done by private consultants that indicates that absent European subsidization, we would have a 20-cent price. You are not familiar with any such—

Secretary LYNG. No, I do not know of that study. I suspect that the pressure from corn sweeteners would make 20 cents seem quite high.

Chairman CHILES. Mr. Secretary, you can tell there has been a lot of interest in your appearance here. I do not know of any witness we have had where we had as many people wanting a second, third and fourth round of questions.

We still have a lot of unanswered questions, and we are certainly looking forward to receiving the 10 to 15 studies you have promised us. The General Accounting Office is going to be doing some work on PIK certificates, its cost and beneficiaries, and maybe that will

help clear up some of the questions we have asked. We thank you for your appearance here today and we look forward to continuing discussions with you.

Secretary LYNG. Thank you, Mr. Chairman.

Chairman CHILES. We will recess our hearings to the call of the Chair.

[Whereupon, at 12:30 p.m., the committee was adjourned.]



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Economic
Research
Service

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Bulletin
Number 499

Farm Sector Financial Problems: Another Perspective

Farm Sector Financial Problems Another Perspective

Agriculture does not have an income problem today as much as it has a problem of absorbing large capital losses. The farm sector's problems center on capital losses and are particularly painful to those farmers whose investment debt is threatened by declining equity values, especially as farmland values decline. The farm crisis reflects the panic and pain associated with facing up to the reality of the loss, uncertainty about who will ultimately bear the loss, and lowered expectations about future market prospects. This report helps us understand the underlying nature of the problem and the essential difference between current income and longer term capital adjustments.

Farming is still basically profitable. But the huge debts incurred—a result of vigorous investment in the late 1970s undercut by declining land values in the 1980s—have overwhelmed the debt-carrying capacity of earnings on some farms. Some of those farmers could support their debts only when they were getting large capital gains, mainly in land values. When the land values fell, debt often exceeded asset values, and the farmers could not get more credit or support the debt they already had. Thus, depending on their debt levels, farmers' financial situations are extremely diverse.

This report examines financial indicators to provide another perspective of today's farm sector:

- o Many farmers are in financial difficulty, others are sound, while still others see this as a time of opportunity for investment and growth.

This perspective, developed by John Lee, Administrator, Economic Research Service (ERS), is based on data and insight from staffs of the Economic Indicators and Finance and Tax Branches of ERS. Adrie Custer, Information Division, Economics Management Staff, provided editorial guidance.

- o Returns to farming have remained relatively stable over recent decades while returns to investing in farming assets, especially land, reflect boom and bust cycles. Thus, farming has remained a profitable activity while many farmers—particularly those heavily indebted—are in trouble.
- o The financial flow (income and returns) indicators for 1978–85 are more favorable to farmers than were the trends of the 1973–78 period, and in current dollars (in which debts are repaid) actual income levels are also higher.

Net Cash Income At Historically High Levels

Net cash income, far from plummeting in the 1980s, has reached record highs (fig. 1). Net cash income, the difference between cash receipts and cash expenses, is a meaningful measure because it expresses cash available for debt management and family living. Data show that net cash income:

- o Was low and stable in the \$12–18 billion range in the 1960s.
- o Rose sharply in 1971–73, then declined sharply during most of the mid-1970s. (The 1976–77 period spawned farmer protest movements and tractorcades.)
- o Has been steadily increasing on a historically high level since 1978.
- o Was a record-high \$39.2 billion in 1984, could approach \$45 billion in 1985, and will likely remain near those record highs in 1986.
- o Is not distributed evenly across types of farms. However, net cash income per farm was higher in 1985 than in 1984 for most types of crop and livestock farms, and much higher than the averages for the 1960s and 1970s.

Even in real terms (adjusted for inflation), the sharp downward trend of the mid-1970s slowed after 1978 and has been relatively flat since 1981. Aside from the runup in the early 1970s, real net cash income for the sector has

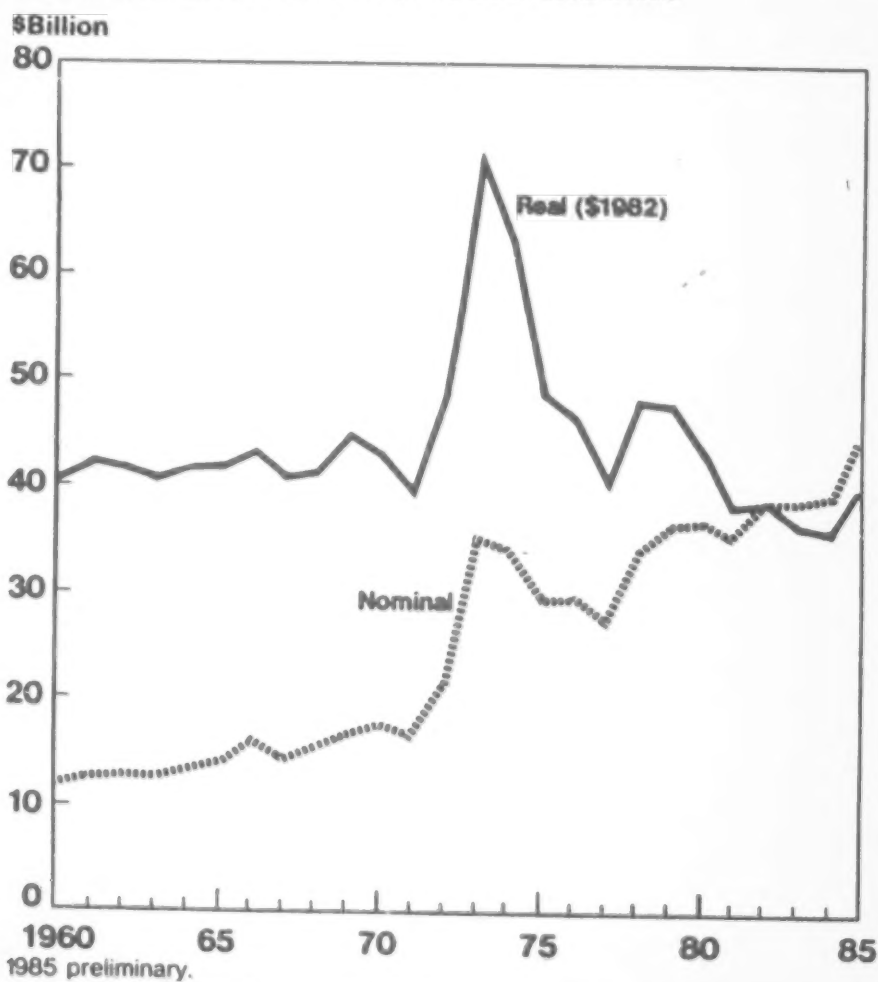
remained close to the level of the 1960s. Since there are about 1.5 million fewer farms today than in the 1960s, average real net cash income *per farm* is much higher in the 1980s.

Net Farm Income Reflects Large Inventory Swings

For 1985, net farm income (as compared with net cash income) was in the \$29–32 billion range, compared with the record-high \$34.5 billion in 1984 (fig. 2). Net farm income data show patterns similar to net cash income:

Figure 1

Nominal and Real Net Cash Income



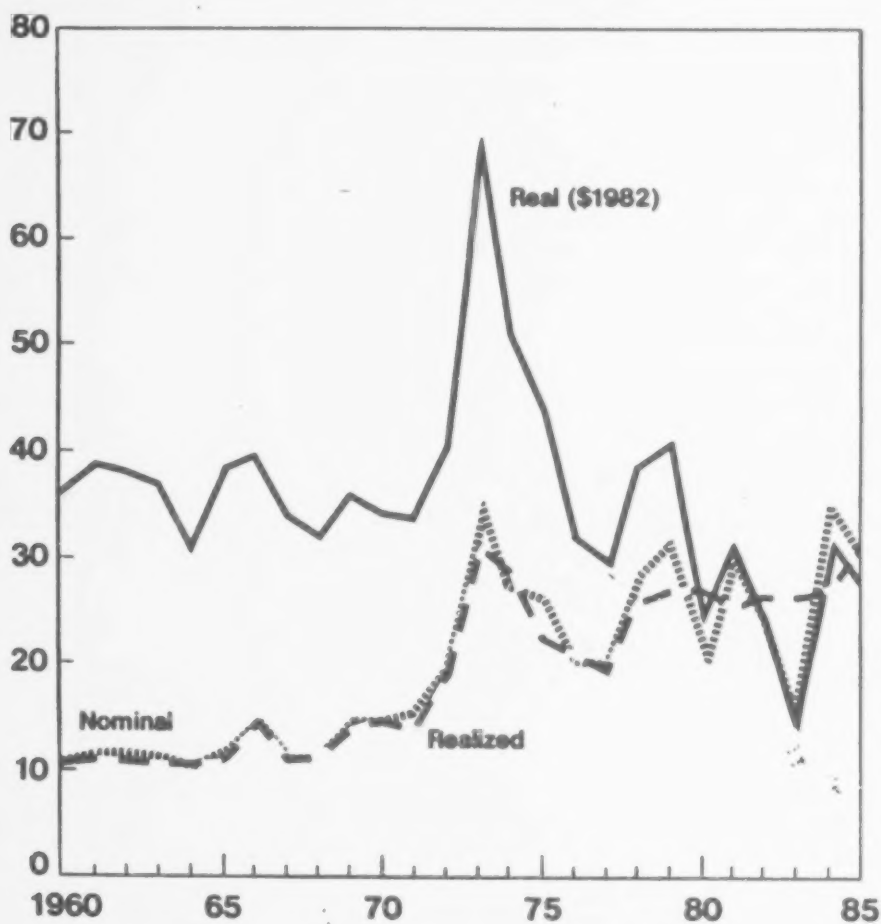
- o Low and flat during the 1960s.
- o Sharp runup in 1971-73.
- o Steady erosion from 1973 to the late 1970s.
- o Highly variable but at a high-trend level since 1978.

Net farm income augments net cash income measures by including noncash incomes (such as the value of homegrown products consumed by households and gross rental value of farm dwellings), noncash costs (such as depreciation on equipment and buildings), and inventory change (adding to or

Figure 2

Nominal and Real Net Farm Income

\$Billion



1985 preliminary.

selling from stored commodities), Net farm income comes closest to being a true economic measure of the value added by farm production activities in a given year. Moreover, since it accounts for noncash costs and incomes and includes depreciation, it is a good measure of long-term economic costs and returns. It is not a good measure of debt-repayment capacity.

Real net farm income showed sharp declines during most of the 1970s, but only modest declines since 1979.

Big swings in inventory changes explain much of net farm income's variability in recent years. If we neutralize the influence of inventory swings (realized net farm income in fig. 2), the trend in real net farm income has been modestly up since 1978, and in the \$24-27 billion range.

Virtually all net farm income is earned on farms having sales of \$40,000 or more annually. Moreover, the proportion of net income accounted for by midsize commercial farms (sales of \$100,000 to \$500,000) has slowly increased since 1981, at the expense of very large and very small farms.

Distribution and Sources of Income Reveal Highly Diverse Farm Sector

Of a total of 2.3 million farms in 1984, 1.6 million were very small with less than \$40,000 in annual sales (table 1). Operators of these farms often did not even regard

Table 1

Distribution and Sources of Income by Sales Class

Value of sales class	1984 farms		Share of cash receipts	Share of government farm payments	Average household income		
	Number (1,000)	Percent			Farm	Nonfarm	Total
					dollars		
Less than \$40,000	1,638	70.3	10.0	11.3	-1,387	20,021	18,634
\$40,000 - 99,999	353	15.2	15.6	22.2	6,073	9,719	15,792
\$100,000 - 499,999	306	13.2	41.7	54.1	44,500	10,902	55,402
\$500,000 and over	31	1.3	32.7	12.4	423,063	14,438	437,501
U.S.	2,328	100.0	100.0	100.0	11,471	17,188	28,659

themselves as farmers because they depended mostly on nonfarm income. They produced only 10 percent of the value of all U.S. farm output, and their household incomes averaged near \$19,000.

The commercial farm sector accounts for most agricultural production and numbers only 600,000 to 700,000 farms. Here's a profile of each commercial farm size category:

- o Small commercial farms (\$40,000 to \$100,000 in annual sales) make up nearly half of all commercial farms, account for 15-16 percent of production, and average less than \$16,000 annual household income, mostly from nonfarm sources. Small commercial farms are disappearing most rapidly (a long-term trend) because many have neither full-time, off-farm jobs nor enough farm resources to generate attractive incomes.
- o Midsize commercial farms (\$100,000 to \$500,000 annual sales) account for another 300,000 farms, produce over 40 percent of all farm output, and average over \$55,000 annual household incomes, mostly from farming.
- o Large commercial farms (\$500,000 annual sales and more) number only 31,000 (1.3 percent of all farms and just under 5 percent of commercial farms), but account for a third of all farm production and average over \$400,000 in annual household income. This group of large farms includes few, if any, grain and oilseed farms, a few cotton and rice farms, and mostly specialty operations such as large feedlots, vineyards, orchards, and greenhouses.

Small and midsize commercial farms get a disproportionate share of direct government farm payments, primarily because relatively fewer large farms produce so-called "program" commodities, such as grains and soybeans.

Off-farm income is the predominant source of household income to small farms, and has exceeded net farm income for the farm sector since the mid-1970s (table 2). Off-farm income, a more stable source of income to farm households, continues to grow. Combined farm and off-farm income to farm households continues to grow in current dollars and often in inflation adjusted dollars.

Despite Debt Reduction, Equity Drops Sharply

After rising steadily through the 1960s and 1970s, the equity of asset owners (farmers and nonoperator landlords) has fallen since 1981. Farmers have reduced their debts slightly, but meanwhile their asset values have dropped over 20 percent from a 1981 peak of over \$1 trillion (fig. 3 and fig. 4).

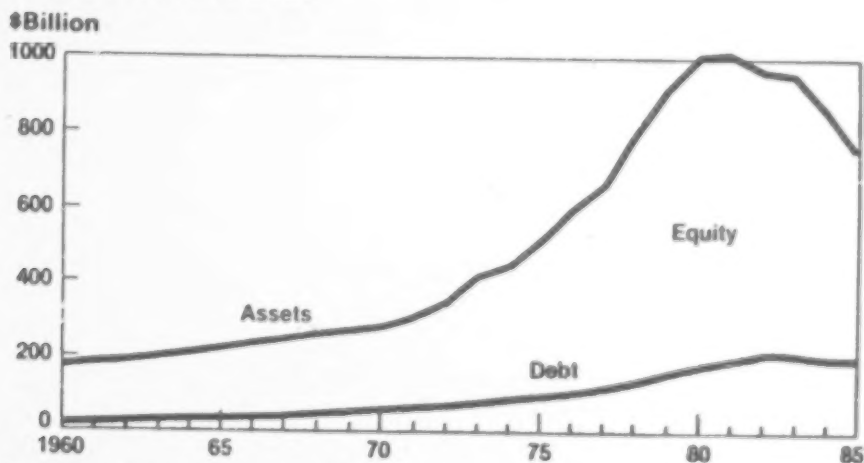
Table 2

Aggregate Income to Farm Households

Year	Net farm income	Off- farm income \$Million	Total income
1960	11,211	8,402	19,693
1965	12,899	12,727	25,626
1970	14,366	17,617	31,983
1975	25,546	23,901	49,447
1980	20,180	35,148	55,328
1981	29,842	36,863	66,705
1982	24,644	37,853	62,497
1983	14,997	38,794	53,791
1984	34,530	40,013	74,543

Figure 3

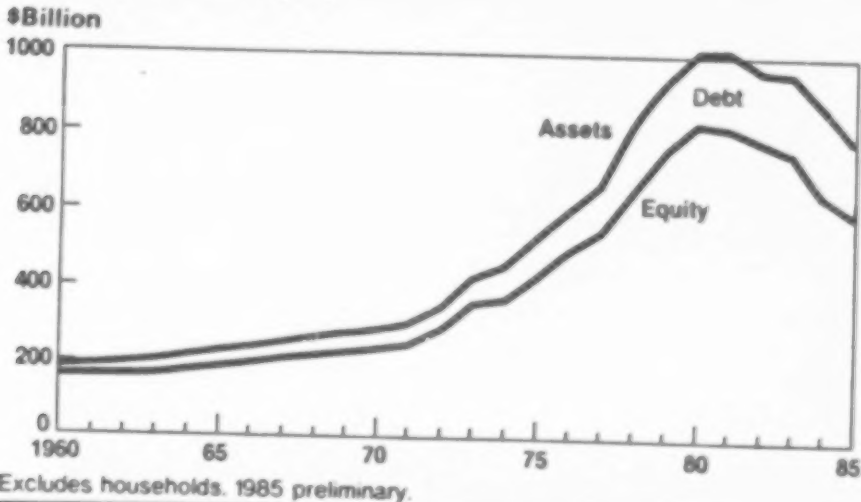
Farm Assets and Debt



Excludes households. 1985 preliminary.

Figure 4

Farm Assets and Equity



Falling equity characterizes the farm financial crisis most vividly. Many farmers who borrowed heavily in the late 1970s were not able to cover debt payments from farm earnings alone. Instead, they counted on being able to occasionally borrow against rapidly rising equity values to meet cash flow needs.

Thus, for them, all that was needed to bring on a crisis was for farmland inflation to slow. As we know, land values not only rose more slowly, but actually declined after 1981 (fig. 5).

Farm Debt-to-Asset Ratio Deceptive

Despite rapidly rising debts in the 1970s, the aggregate ratio of debts to assets stayed deceptively stable because asset values also rose rapidly (fig. 6). When asset values began to drop after 1981, the debt/asset ratio soared. Although debts were no longer rising much, asset values were falling.

The farm sector in the 1970s was considered financially solid because its ratio of debts to assets was running well below that typical of other sectors of the economy. That view can be misleading because agriculture uses more capital relative to sales than other sectors of the economy. Most *Fortune* 500 corporations, for example, have annual sales in excess of total company assets. However,

Figure 5

Percent Change in Average Value of Farm Real Estate Per Acre



Top No.: Change from 1985 to 1986

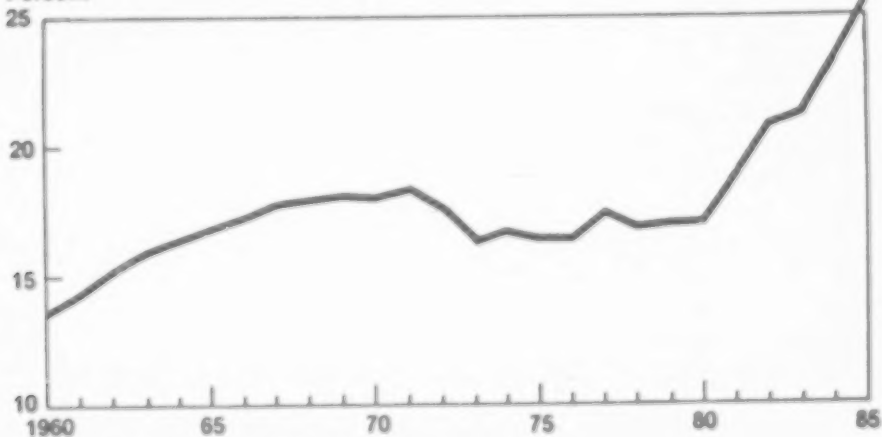
Bottom No.: Change from 1981 to 1986

April 1, 1985 - February 1, 1986 and
February 1, 1981 - February 1, 1986

Figure 6

Farm Debt-to-Asset Ratio

Percent



Excludes households. 1985 preliminary.

agriculture invests \$5 to \$6 of capital for every dollar of sales generated. Thus, agriculture cannot support as high a debt-to-asset ratio as other sectors.

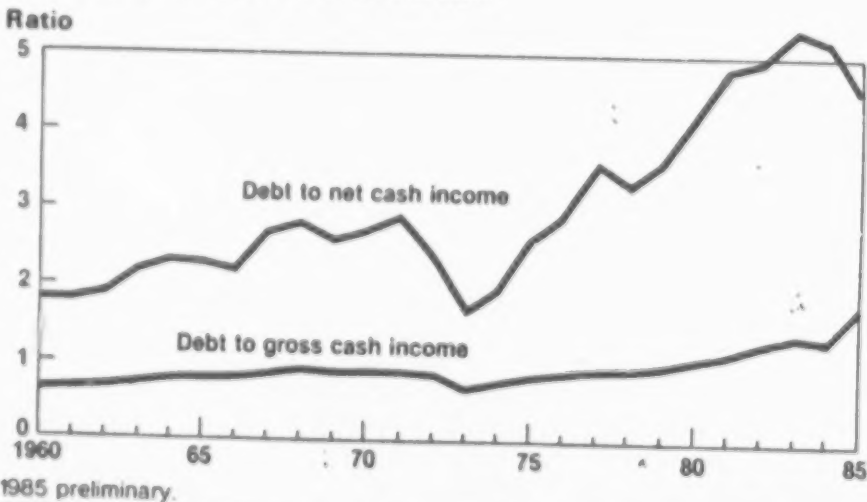
Debt-Carrying Burden of Income Heavy

The heavy burden of agriculture's debt is reflected in the high debt-to-income ratio shown in figure 7:

- o Even with a debt-to-asset ratio in the 20- to 26-percent range that has prevailed, the ratio of debt to sales (gross cash income—bottom line in figure 7) is roughly 1 to 1.
- o The debt burden on net cash income is even greater, now about 5 to 1, as the top line in figure 7 shows.
- o The debt-carrying burden on net cash income is not new. It rose sharply after 1973, and has moderated, even declined slightly, since 1983.
- o Until 1981, the farm sector dealt with its debt problem by living off the rapid inflation in land values.

Figure 7

Ratio of Farm Debt-to-Cash Income



Returns to Farming Stable; Returns to Landownership Tumble

Changes in income from landowning is the real source of any crisis in agriculture, not changes in income from farming. Returns on assets from residual income (that is, from the farm operation itself) have been relatively stable over the last three decades (fig. 8). Over half the returns on farm investment in the 1970s came in the form of capital gains. Those total returns (returns to farming plus capital gains) encouraged farmers to bid up land values to get access to those returns.

Rising Debt and Interest Rates Pinch Cash Flow

The combination of rising debts and rising interest rates began to take its toll on the financial flexibility of many farms after 1973 (fig. 9).

The widening interest payment spread between 1973 and 1979 reflected growing farm debt because interest rates were still relatively low. The rapidly widening spread after 1979 reflected sharply higher interest rates on the increasing debt. Thus, cash flow (cash income plus net borrowing) after interest payments was sharply reduced.

Figure 8

Rate of Return from Farm Assets

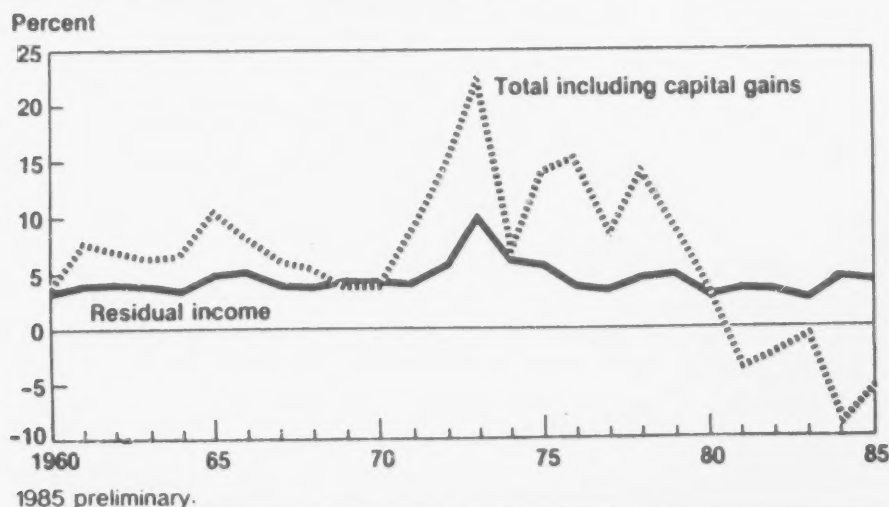
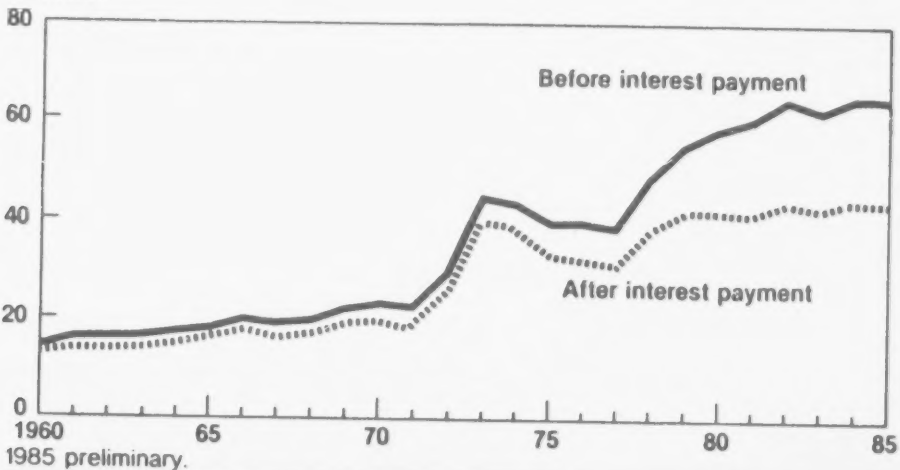


Figure 9

Farm Cash Flow

\$Billion



Since the farm debt is highly concentrated on less than half the farms, heavily indebted farms are affected more than shown in figure 9, and low-debt farmers are much better off than shown.

Return Rate on Investment Begins To Improve

The average rates of return on assets and equity held in the 4- to 5-percent range in the 1960s, soared in the 1971-73 period, and then declined from 1973 to 1983 (fig. 10 and table 3). Since 1983, stable incomes and falling asset and equity values have caused average rates of return on investment to improve again. Rates of return on new investment are likely higher than average rates of return on all assets and equity. Rates of return on investment determine whether capital will flow into or out of the farm sector.

Financial Stress Reflects Heavy Indebtedness

About 213,000, or nearly 13 percent of the 1.7 million farm operators represented in a 1985 survey, had debts equal to 40 percent or more of the value of their assets, and negative cash flows as of January 1, 1985 (table 4). Financial analysts view farms with these characteristics as being the most financially vulnerable. These operators held about 45 percent of total debt held by operators (not of total farm sector debt).

The debt/asset categories shown in table 4 are somewhat arbitrary but are generally used by financial analysts to reflect the progression of debt distribution from those farmers whose net worths are relatively strong, to those whose assets are worth less than the debts owed.

Cash flow is what is left after paying all production expenses, all debt principal and interest payments, and allowing about \$13,000 for household expenses. Table 4 probably overstates the number of operators in serious financial trouble because:

Figure 10

Rate of Return on Investment

Percent

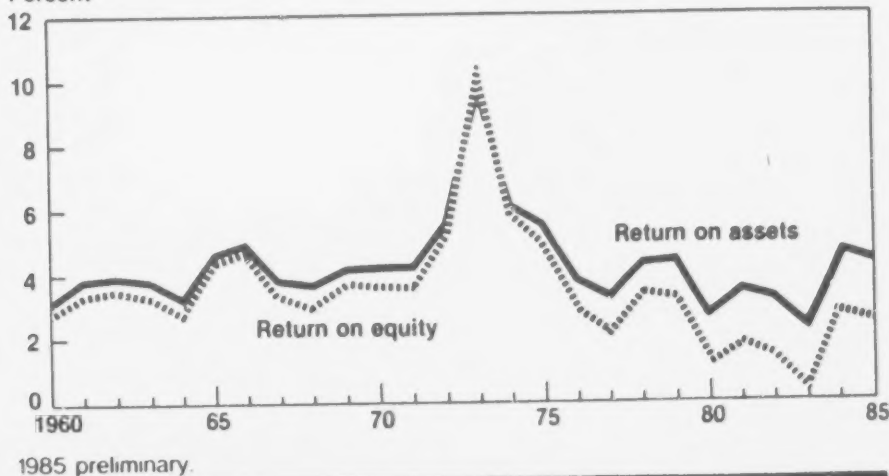


Table 3

Returns to Assets and Equity 1/

Item	1960	1970	1975	1980	1981	1982	1983	1984	1985 p	1986 f
Percent										
Return to assets										
from:										
Income	3.1	3.9	4.7	2.4	3.4	3.2	2.4	4.8	4	3-5
Capital gains	.1	.2	7.4	.4	-7.3	-5.7	-3.0	-14.1	-7	-1-3
Total	3.2	3.7	12.1	2.8	-3.9	-2.5	-.6	-9.3	-2	1-3
Return to equity										
from:										
Income	2.7	3.5	4.9	1.1	1.8	1.3	.2	2.8	3	1-3
Capital gains	.2	-.3	10.3	.5	-8.8	-6.9	-3.8	-16.1	-9	-2-4
Total	2.9	3.2	15.2	1.6	-7.0	-5.5	-3.5	-13.3	-6	0-2

1/ Excluding farm households. 1985 preliminary and 1986 forecast.

Table 4

Farms in Financial Stress

<u>Characteristics</u>	<u>Farms</u>	<u>Assets</u>	<u>Debts</u>
	<u>No.</u>	<u>\$Million</u>	
Farms with negative cashflows and debt/asset ratios over 100%	37,000	9,000	13,000
Farms with negative cashflows and debt/asset ratios from 70 to 100%	55,000	18,000	15,000
Farms with negative cashflows and debt/asset ratios from 40 to 70%	121,000	51,000	27,000
Total above	213,000	78,000	55,000

- o Many small operators traditionally spend less than \$13,000 annually for family living, even in good times.
- o Principal payments can often be postponed or restructured.

Financial stress can be found among all farm size groups, farm types, and geographic regions, but is most concentrated in:

- o Farms with sales of \$40,000 to \$250,000 annually.
- o Cash grain, general crop, and general livestock farms.
- o Farms in the Lake States, Northern Plains, and Corn Belt (these three regions account for over 60 percent of all farms in stress).

**Agricultural Banks Vulnerable;
Rural Credit System Strong**

Many lenders face financial difficulties, but the credit system serving agriculture is basically sound and loan funds are plentiful for creditworthy borrowers. There are about 14,000 commercial banks. About 5,000 of them are classified as agricultural banks (meaning 17 percent or more of their loans are to agriculture).

Since 1983, the number of "potentially vulnerable" banks has risen from 419 to 806 (table 5). Agricultural banks are

Table 5

A Look at Agricultural Banks

	<u>Commercial bank failures</u>			
	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>Total</u>
Total	44	77	118	239
Agricultural banks*	7	31	69	108
Rural banks	15	41	81	137

*Federal Reserve Board definition: 17 percent or more of loans to agriculture.

	<u>FDIC-designated problem bank list</u>	
	<u>Dec. 31, 1985</u>	
Total	1,098	
Agricultural banks*	437	

*FDIC definition: 25 percent or more of loans to agriculture.

	<u>FRB-designated potentially vulnerable banks</u>	
	<u>Dec. 31, 1985</u>	
Total	806	
Agricultural banks (17% definition)	332	

about 44 percent (332) of the total, compared with 23 percent (96) in 1983.

Sixty-nine agricultural banks failed in 1985, bringing the total failures since 1983 to 108. Over half the bank failures were in the Corn Belt and Northern Plains. Analysts expect bank failures to level off in 1986 and then to gradually decline.

These failures are serious, but pose no threat to the banking system or to rural credit availability. In all but a few cases, the banks reopened within a few days under new ownership. Almost all the purchasers were nearby small- to medium-size banks or bank holding companies. None were large money-center banks.

Most FmHA Farm Borrowers Sound

Only 31 percent of all loans made by the Farmers Home Administration (FmHA) were delinquent on September 30, 1985, representing only 21 percent of the loan principal

outstanding (table 6). In other words, nearly 70 percent of the loans and 80 percent of the principal outstanding were current.

As a lender of last resort, FmHA would be expected to have the most seriously troubled portfolio of all lenders. The percentage of delinquent FmHA cases rose from 1980 to 1983, but has been relatively stable since 1983. The vast majority (about 80 percent) of delinquent FmHA loans fall in the Emergency Disaster and Economic Emergency loan categories, not in the category of traditional limited resource and beginning farmer loans.

The Farm Credit System (Federal land banks and Production Credit Associations), the largest holder of farm debt, suffered major losses in 1985 and will again in 1986 as it digests its portfolio of troubled loans. It remains to be seen whether the system will require Federal assistance.

Table 6

Farmers Home Administration Farmer Program Delinquencies by Program, September 30, 1985

Farmer programs (Individual loans)	Number of active cases 1/ (caseload)			Principal outstanding		
	Delinquent			Delinquent		
	Total	Total	Proportion	Total	Amount	Share of
	- - Number - -	- -	Percent	- - \$Million - -	- -	Percent
* Farm ownership (FO)	124,909	26,007	20.8	7,449.0	344.2	4.6
Farm ownership nonfarm enter- prises	1,361	345	25.4	52.3	3.7	7.0
* Operating loans excluding youth (OL)	132,042	37,809	28.6	6,157.9	821.2	13.3
Operating loans youth	1,769	576	32.6	5.7	1.8	30.8
* Emergency disaster (ED)	121,709	47,276	38.8	9,862.2	3,656.6	37.1
* Economic emergency (EE)	56,605	24,245	42.8	4,140.1	963.1	23.3
Recreation	210	53	25.2	13.3	1.3	9.5
Soil and water	16,441	4,465	27.2	302.1	33.6	11.1
Economic opportunity	431	399	92.6	.5	.5	97.0
Total	455,477 1/	141,175 1/	31.0 1/	27,983.0	5,825.8	20.8

1/ Duplicated cases because some borrowers have loans under several different programs. The number of cases is the number of loans, not the number of borrowers. On September 30, 1985, there were 278,982 unduplicated borrowers under FmHA farmer programs of which 79,584 (28.5 percent) were behind schedule in making payments.

Sources: Farmers Home Administration, Farm and Housing Activity Report for September 30, 1985, and 616 report for September 30, 1985.

Many lenders feel that most of the troubled borrowers and vulnerable loans have emerged. These lenders see opportunities for making successful new loans but feel it will take several years to "work off" the old bad debt.

Financial Prospects Reflect Adjustments Underway

Excess supplies of most commodities combined with weak markets foretell somber price and income prospects, probably for several more years. To face these somber realities and the need to compete in a tough world market, U.S. agriculture is restructuring its capital structure and its production processes.

- o The capital structure of the farm sector is being restructured to reduce over-capacity and increase efficiency. Thus, since 1981, depreciation of capital stock has exceeded new capital expenditures, leading to net drawdown of farm capital (table 7).
- o Production processes are being restructured to lower both costs and the need for credit. For example, new irrigation development has virtually stopped; per acre use of potash and phosphate has declined since 1981 for several major crops (table 8), and more farmers are adopting reduced tillage practices.

Table 7

Net Capital Formation ^{1/}

Year	Gross capital expenditures	Depreciation	Net	Year	Gross capital expenditures	Depreciation	Net
	-\$Million-				-\$Million-		
1960	4,003	3,690	313	1973	10,172	7,389	2,783
1961	4,022	3,720	302	1974	11,444	8,813	2,631
1962	4,473	3,830	643	1975	12,378	10,450	1,928
1963	4,846	3,946	900	1976	13,968	11,644	2,324
1964	5,101	4,085	1,016	1977	15,015	13,020	1,995
1965	5,566	4,239	1,327	1978	17,948	14,188	3,760
1966	6,095	4,531	1,564	1979	19,874	16,117	3,757
1967	6,834	4,861	1,973	1980	17,982	17,550	432
1968	6,148	5,241	907	1981	16,846	19,281	-2,435
1969	6,214	5,524	690	1982	13,655	19,570	-5,905
1970	6,793	5,785	1,008	1983	13,027	19,300	-6,273
1971	6,789	6,222	567	1984	12,454	18,825	-6,371
1972	7,480	6,598	882	1985p	11,600	18,091	-6,491

p = Preliminary.

^{1/} Excludes operator households.

Financial prospects for 1986 include sharply lower cash sales, lower expenses, larger Government payments, slightly lower net cash income, lower net farm income, slowing declines in asset values, and a decline in debt outstanding (table 9).

Net Cash Income Prospects

Net cash income reached an all-time high of \$39.2 billion in 1984, could approach \$45 billion in 1985, and will likely remain near those record highs in 1986. Specifically:

Table 8

Fertilizer Application Rates, Selected Crops

	<u>Nitrogen</u>	<u>Phosphate</u>	<u>Potash</u>
	<u>Annual percentage change</u>		
Wheat:			
1972-80	3.0	0.9	1.4
1981-85	.9	-2.6	-5.4
Corn:			
1972-80	1.9	.2	3.0
1981-85	.6	-2.7	-.6
Soybeans:			
1972-80	2.7	1.2	4.2
1981-85	-4.3	-1.5	-1.2

Table 9

Net Cash Income Prospects

	<u>1983</u>	<u>1984</u>	<u>1985p</u>	<u>1986f</u>
			<u>\$Billion</u>	
Cash receipts	136.3	141.8	142 to 144	129 to 133
Gov't. payments	9.3	8.4	7 to 9	10 to 13
Farm related income	2.5	3.0	2 to 4	2 to 4
Gross cash income	148.1	153.3	152 to 155	145 to 149
Cash expenses	109.8	114.1	109 to 111	101 to 105
Net cash income	38.3	39.2	43 to 46	42 to 46
Deflated (1982 \$)	36.9	36.3	38 to 41	36 to 40

1985 preliminary and 1986 forecast.

- o With pressure on crop prices, overall cash receipts are likely to decline significantly in 1986.
- o Government payments will be record high and in the \$10-13 billion range.
- o Overall gross cash income should be somewhat lower in 1986 than in 1985.
- o Cash expenses are expected to decline substantially in 1986.
- o Thus, nominal (nondeflated) net cash income will remain only slightly below the historically high levels of 1984 and 1985.

Net Farm Income Prospects

The final estimate for net farm income in 1985 will be close to \$30 billion (table 10). And for 1986, net farm income will slip to the \$26-30 billion range. This decline, as contrasted with stable, high cash income, reflects mainly declines in nonmoney income and negative inventory swings.

Net farm income comes closest to being a true economic measure of the value added by farm production in a given year. Thus, one would expect net farm income to be low in a year with a PIK (payment-in-kind) program (even though farmers' cash incomes were high because they were selling inventories) and high in a year when production was large.

Table 10

Net Farm Income Prospects

	<u>1983</u>	<u>1984</u>	<u>1985p</u>	<u>1986f</u>
			<u>\$Billion</u>	
Gross cash income	148.1	153.3	152 to 155	145 to 149
Nonmoney income	13.1	12.9	11 to 13	10 to 12
Inventory change	-10.6	7.8	-4 to -1	-6 to -2
Gross farm income	150.6	174.0	163 to 166	152 to 156
Production expenses	135.6	139.5	133 to 135	124 to 128
Net farm income	15.0	34.5	29 to 32	26 to 30
Deflated (1982 \$)	14.4	31.9	26 to 29	23 to 26

1985 preliminary and 1986 forecast.

Table 11

Farm Production Expense Prospects

Item	1983	1984	1985p \$Billion	1986f
Farm origin inputs	33.1	33.4	31 - 33	29 - 33
Manufactured inputs	21.3	23.1	21 - 23	17 - 21
Interest	21.4	21.1	19 - 21	16 - 20
All others	59.8	61.8	59 - 61	56 - 60
Total	135.6	139.5	133 - 135	124 - 128

1985 preliminary and 1986 forecast.

These expectations are accurate. Net farm income in 1983 (a PIK program year) was \$15 billion, then climbed to a record \$34.5 billion in 1984 because production was large and prices were still high as a result of 1983's PIK program.

Farm Production Expense Prospects

Farmers are getting their production costs under control (table 11):

- o Interest expenses are declining as both new debt and interest rates fall.
- o Prices of some manufactured inputs (like fuels, oils, fertilizers, and pesticides) are declining, while farmers are purchasing less machinery, equipment, and confinement livestock facilities.
- o Farm production expenditures were down in 1985 and are expected to decline further in 1986.
- o Commodity cost of production data compiled by ERS suggest that some per acre and per unit costs have stabilized or modestly declined.

Debt and Asset Prospects

During calendar 1985, farm sector asset values declined about 8-10 percent (table 12). Declines were heaviest in the Corn Belt and Northern Plains. Total farm debt also declined, to an expected \$195-202 billion on December 31.

Table 12

Balance Sheet of the Farming Sector

<u>Item</u>	<u>1983</u>	<u>1984</u>	<u>1985p</u>	<u>1986f</u>
			<u>\$Billion</u>	
Assets:				
Real estate	736.1	639.6	535 to 585	510 to 570
Total assets	956.5	856.1	755 to 805	725 to 775
Liabilities:				
CCC loans	10.8	8.7	14 to 18	17 to 21
Total liabilities	202.5	198.9	195 to 202	194 to 201
Total farm equity	754.0	657.2	555 to 605	525 to 585
			<u>Ratios</u>	
Selected ratios:				
Debt-to-asset	21.2	23.2	25 to 27	24 to 28

1985 preliminary and 1986 forecast. Excludes operator households.
As of December 31.

Large declines in regular debt were partly offset by increases in Commodity Credit Corporation (CCC) loans. Total farm operator debt is expected to decline substantially over the next 2-3 years as CCC lending levels off and declines and as unpayable loans are written off. The debt and asset accounts shown in table 12 measure farm sector wealth (not farm operator wealth).

Long-Term Prospects

Projections beyond 1986 are sensitive to many economic and institutional forces, but especially U.S. and world monetary and fiscal developments.

One view is that, after delaying making adjustments to new market conditions in 1981, 1982, and 1983, we made large adjustments, especially in land values, in 1984 and 1985, and will make further—but less dramatic—adjustments in 1986. By the end of 1986 or 1987, we will have made the bulk of the necessary adjustments to the current fundamentals of supply and demand. Further modest adjustments could take place as the 1985 Food Security Act expires (in 1990) if Government payments are phased down.

That does not mean that all is rosy beyond 1986-87. Lenders continue to hold substantial assets that must be

liquidated, and there are no obvious signs of dramatic resurgence in demand, hence in prices, for farm commodities. Thus, we likely face several more lean years:

- o There will continue to be some fine tuning of asset values in some local areas.
- o Debts will gradually be restructured and lowered.
- o Equity will begin to stabilize after next year.
- o While some will lose their farms, some new and existing farmers will see attractive opportunities.
- o In terms of being able to pay for land or begin farming by renting, the ability to "cash flow" out of current earnings (not inflation) may be the best since the early 1970s.



CREDIT AND ASSET SALES

THURSDAY, FEBRUARY 19, 1987

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:10 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Lawton Chiles (chairman of the committee) presiding.

Present: Senators Chiles, Sasser, Exon, Lautenberg, Simon, Sanford, Wirth, Conrad, Symms, Grassley, Nickles, and Rudman.

Staff present: Richard N. Brandon, staff director; and Jim Carr, group leader for tax policy, housing and credit.

For the minority: G. William Hoagland, staff director; and Carol Hartwell, senior analyst for housing credit.

OPENING STATEMENT OF CHAIRMAN CHILES

Chairman CHILES. Good morning. Today, the Budget Committee welcomes a panel of well-known experts on economic matters.

We have with us John Shad, the Chairman of the Securities and Exchange Commission, Dr. Martin Feldstein of the National Bureau of Economic Research, Dr. Alan Greenspan, president of Townsend and Greenspan, and Mr. Fleischman, one of the SEC Commissioners.

Our subject is asset sales, and although you will not find him at the witness table, I have a feeling Mr. Chiswell Langhorne is with us today, as well.

Mr. Langhorne won great fame in the 1870's as the originator of the auctioneer's chant at tobacco sales. I think he would look on the idea of selling assets as something right up his alley.

The Federal Government has assumed the role of auctioneer. We are selling off the assets to reduce our debts. It is not the kind of auction where the seller can pull back the goods if the reserve price is not met.

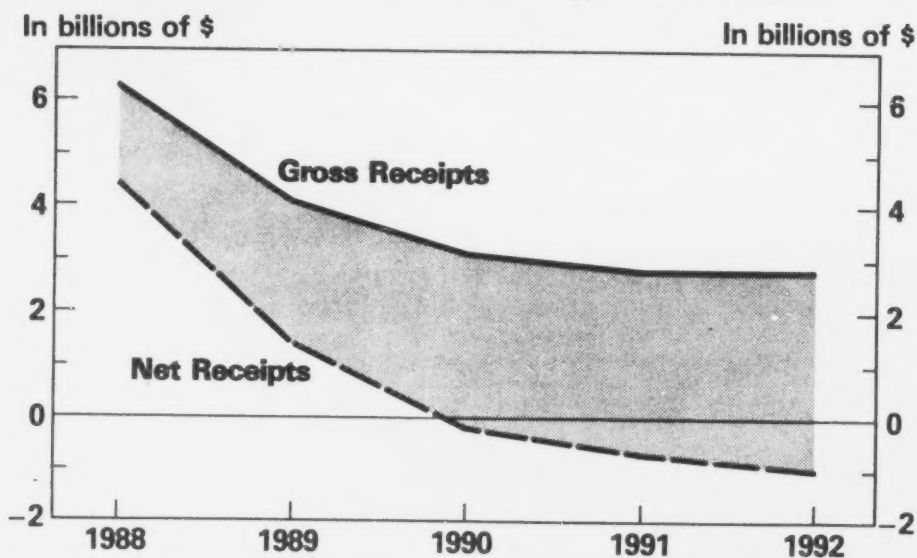
We are going to sell off loans made by Farmers Home, REA, the Export/Import Bank, the Veteran's Administration, and take what is offered. Much the same thing was done last year when some \$6 billion in asset sales was included in the budget.

I thought it was a lousy way to dance around the budget deficit last year and I think it is just as lousy this year.

Figures prepared by the Congressional Budget Office suggest that this year's loan sales will yield about 41 percent of the face value of the loans, and while the sales of these assets lower the outlays in the years in which they are sold, the deficits down the road are increased by at least as much as the loan sales receipts.

(93)

Deficit Impact of President's Loan Sales from Existing Portfolios



Senate Budget Committee Staff, February 18, 1987

In fact, by 1992 the interest and principal payments we surrender will equal some \$3.8 billion—more than offsetting the \$2.8 billion of deficit reduction loans sales scheduled for that year. In the 5 years of 1988 through 1992 foregone receipts will total more than \$15 billion.

ASSET SALES WILL NOT REDUCE DEFICIT

These assets are not going to do anything for genuine deficit reduction. They will not reduce the structural deficit at all. In fact, asset sales are exactly the kind of budget gymnastics that will leave us flat on our faces later.

Even without the deficit concerns, there are other things to worry about. The last several months have shown that at the highest levels of high-finance, the search for quick profits has reached a new low.

So what happens next? We go out and put \$7 billion worth of new paper on the market with no experience on how to sell it or price it. I wonder if we can set up a fail-safe mechanism to guard against people lining their pockets by setting low prices or high handling fees. It seems to me that we need registration matched with some very intense supervision, both by the regulatory agencies and by the Congress.

Gentlemen, out of the good intentions to reduce the deficit I think has come a bad idea. I am not convinced that we will get our money's worth in return, nor am I persuaded the effect on the deficit will be substantial.

If all of this makes it sound like I am an opponent of asset sales, that is wrong. I am an enemy. I do not think they will work. I think they are camouflage. They are a waste of time and I think

they could end up being a waste of the money we are trying to save. Asset sales are like that family in town everyone thinks is wealthy, when in fact they are down on their luck and they are slipping out the back door and pawning a piece of furniture or a piece of jewelry just to continue their same standard of living.

I am really interested in what you have to say this morning. I hope we will come up with a way to minimize the damage this time around and I hope the Committee and the Congress will have the courage to find a genuine way to cut the deficit.

I call on our ranking member this morning, Mr. Rudman, who certainly is interested in the deficit. He led the charge and was part of the genesis of the idea of Gramm-Rudman-Hollings to try to make us face up to the deficit and we are delighted to have him.

Senator RUDMAN. I thank the chairman very much. I particularly thank him for that very diffident and hesitant statement about the administration's policy on asset sales. This is a great committee, Mr. Chairman. I have been here since only January 20 and I have moved up rather quickly. I like the way you run this place.

Senator Domenici unfortunately, had several conflicts this morning and hopes that he can get here a little later on. I welcome the very distinguished panel we have before us. Actually, I asked Mr. Shad before the hearing if he had any good stock tips but he was very tight lipped.

We will look forward to all of their testimony. I would, Mr. Chairman, like to introduce in the record at this point the opening statement of the ranking member of your committee, Senator Domenici.

Chairman CHILES. Without objection.

Senator RUDMAN. I thank you.

[The prepared statement of Senator Domenici follows:]

OPENING STATEMENT
 SENATOR PETE V. DOMENICI
 HEARING ON LOAN ASSET SALES
 FEBRUARY 19, 1987

MR. CHAIRMAN, IF ONE WERE TO READ DOWN THE LIST OF HEARINGS THAT THE BUDGET COMMITTEE IS HOLDING THIS YEAR, HE OR SHE WOULD SEE ALL OF THE MAJOR ISSUES OF THE DAY -- EDUCATION, WELFARE REFORM, MEDICARE, TRADE AND COMPETITIVENESS, DEFENSE, LOAN ASSET SALES. ASSET SALES?

I HAVE TO ADMIT THAT IT IS HARD TO GENERATE A LOT OF ENTHUSIASM ABOUT THIS SUBJECT. BUT I BELIEVE THAT IT IS TIME FOR CONGRESS TO STOP AND TAKE A CLOSER LOOK AT THE POLICY WE ALL EMBRACED LAST YEAR.

IF ANY OF YOU HAVE DOUBTS ABOUT THE IMPORTANCE OF LOAN ASSET SALES IN THE FY 87 BUDGET, LET ME CITE SOME STATISTICS.

- LAST FALL'S RECONCILIATION BILL INCLUDED \$5.6 BILLION IN OUTLAY SAVINGS FROM LOAN SALES AND REFINANCINGS. THAT'S ALMOST HALF OF THE TOTAL FOR THE BILL.
- WHEN YOU TAKE APPROPRIATIONS AND OTHER ACTIONS INTO ACCOUNT, LOAN SALES MAKE UP ONE-FIFTH OF THE TOTAL DEFICIT REDUCTION ACHIEVED IN THE CURRENT YEAR BUDGET.

(2)

WHY DID WE DO IT? SOME WILL ARGUE THAT SELLING LOANS IS GOOD PUBLIC POLICY, BECAUSE IT REDUCES THE GOVERNMENT'S PRESENCE IN THE CREDIT MARKET.

WE CAN DEBATE THE MERITS OF THIS ARGUMENT, BUT THERE CAN BE NO DEBATE ON ONE POINT. CONGRESS DID NOT DECIDE TO SELL LOANS TO GET THE GOVERNMENT OUT OF THE CREDIT BUSINESS. IN FACT, JUST THE OPPOSITE IS TRUE. THE IDEA OF SELLING LOANS FIRST CAME UP AS A WAY TO AVOID CUTTING PROGRAMS.

THE REASON CONGRESS INCLUDED LOAN SALES IN LAST YEAR'S BUDGET WAS TO REDUCE THE DEFICIT, PURE AND SIMPLE. WE NEEDED SAVINGS TO MEET THE DEFICIT TARGET SET BY GRAMM-RUDMAN-HOLLINGS AND COULD NOT REACH THAT GOAL THROUGH SPENDING CUTS AND REVENUE INCREASES ALONE.

I WOULD REMIND MY FRIEND, THE CHAIRMAN, THAT THE BUDGET RESOLUTION PASSED BY THE SENATE LAST YEAR INCLUDED ONLY \$1.2 BILLION IN OUTLAY REDUCTIONS FROM LOAN SALES. IT WAS IN CONFERENCE THAT THE USE OF THIS DEVICE REALLY BEGAN TO GROW.

LATE ONE NIGHT, WHEN NO REAL CUTS COULD BE NEGOTIATED WITH OUR FRIENDS IN THE HOUSE, THE TOTAL FOR LOAN SALES AND REFINANCINGS INCREASED TO \$3.1 BILLION. AND AS I MENTIONED EARLIER, BY THE TIME WE HAD FINISHED ACTION ON RECONCILIATION, THE TOTAL WAS UP TO \$5.6 BILLION.

(3)

BUT THAT IS HISTORY. THE QUESTION NOW IS WHETHER MORE SALES SHOULD BE INCLUDED IN THE FY 88 BUDGET.

SOME WILL SAY NO; THAT SELLING LOANS IS THE WORST FORM OF "SMOKE AND MIRRORS." OTHERS WILL WANT TO HOLD ONTO THE OPTION IF FOR NO OTHER REASON THAN TO MEET THE GRAMM-RUDMAN-HOLLINGS TARGETS.

I SUBMIT THAT IT IS TIME TO STEP BACK AND CONSIDER WHETHER ASSET SALES MAKE SENSE AS A WAY TO REDUCE THE DEFICIT.

CERTAINLY, IT WOULD BE BETTER TO CUT SPENDING. FOR EXAMPLE, SELLING OLD LOANS DOES NOTHING TO REDUCE NEW LENDING BY THE GOVERNMENT, WHICH TOTALS AROUND \$40 BILLION A YEAR. IT SIMPLY ALLOWS CONGRESS TO AVOID MORE DIFFICULT SPENDING CUTS.

BUT IS SELLING LOANS WORSE THAN THE ALTERNATIVES? WOULD WE BE BETTER OFF BORROWING? OR WOULD WE BE BETTER OFF TAXING THE AMERICAN PEOPLE JUST THAT MUCH MORE? IN AN ECONOMIC SENSE, HOW DO ASSET SALES STACK UP AGAINST THE ALTERNATIVES?

I AM PLEASED TO JOIN THE CHAIRMAN IN WELCOMING SUCH A DISTINGUISHED PANEL OF WITNESSES AND LOOK FORWARD TO HEARING YOUR VIEWS ON THESE AND RELATED QUESTIONS.

Chairman CHILES. Mr. Shad, we will call on you to open up for us.

STATEMENT OF JOHN SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY EDWARD FLEISCHMAN, SEC COMMISSIONER

Mr. SHAD. Well, I was hoping you were going to start on the mountaintop with the distinguished people to my left and let the SEC get down to the canyon of Wall Street from the mountaintop to talk about the mechanics.

I am principally going to talk about the mechanics of implementing the asset loan sales.

The Securities and Exchange Commission is pleased to testify concerning the applicability of the Federal securities laws to the sale of Federal Government loan assets mandated by the Omnibus Budget Reconciliation Act of 1986.

REGISTRATION OF SECURITY OFFERINGS

The principal purposes of the Federal securities laws are to protect investors and maintain fair and orderly securities markets. How the securities laws may apply to the loan asset sales will depend upon how the transactions are structured and consummated. Registration of securities offerings permits a broad public distribution to a large number and range of institutional and individual investors and the creation of an active market in the securities.

If an offering requires registration under the Securities Act and the registration statement is well-prepared by experienced securities lawyers, it should become effective within 30 days after filing. One of the concerns that has been expressed is the time period involved in complying with the registration requirements. The SEC and its staff are prepared to give full support and try to facilitate this major effort within the time constraints of the statutes and other requirements.

If a registration statement requires major modifications—the timing of the the effective date will depend upon how quickly the financial advisers and attorneys for the issuers are able to provide the necessary information. Two particular areas of concern in the review process will be the availability of loan documentation and the loan loss experience.

In addition, the costs of registered underwritten public offerings generally are greater than the costs associated with private placements or unregistered distributions. Although it is not always the case, a registered offering also probably will take longer than a private placement or unregistered distribution. I would like to point out, however, that the registration costs may be more than offset by the possibility of a higher price for the securitization of these loans.

In unregistered private placements it is common for institutional investors to require similar and sometimes more information than that required in a registration statement, as well as more stringent terms and a lower price, justified in part by the lack of liquidity.

Investors cannot readily sell most types of unregistered securities in the open market. They are referred to as "lock-ups;" and, all

other things being equal, lock-ups or illiquid securities may sell, or typically do sell, at a 10 percent or larger discount from readily marketable securities. In other words, those are securities that are fully registered and have an established public trading market. I would note that I am being conservative when I suggest a 10 percent discount. The rule of thumb generally would be even higher than that.

Such a discount would significantly exceed the greater cost of a registered offering. Also, compliance with the registration requirements facilitates comparative analysis of the securities offered with already publicly traded issues. Possible exemptions from registration—and there are several—are summarized in our written statement, the principal one being private placement with institutional investors.

TAX ADVANTAGE TO INVESTORS

There are also possible tax advantages to investors if interests in the loans are sold through a registered investment company. In the case of poolings of large numbers of relatively small loans, that is one worthwhile option to be considered.

Regulated investment companies are not subject to separate Federal corporate income taxes, so that the distributions of dividends, interest, and capital gains from such investment companies are subject only to the federal tax payable by the shareholders as if they held the securities directly.

There are, of course, a number of possible exemptions to the Investment Company Act, which are summarized in our written statement. The processing of a request for exemptive relief from the Investment Company Act would require 30 to 45 days, partially as a result of certain statutory requirements that have to be met. Generally the overall time span on doing a registered public offering of an investment company would range in the area of 45 days.

We would suggest that the important job that has to be done in these financings is that the financial advisers and legal counsel to the agencies must carefully analyze the size and nature of each financing, the quality of the loans to be sold, and the current market conditions in order to determine whether a registered public offering, directly or through an investment company, a non-registered private placement, or a combination of these alternatives is the most advantageous means of selling large whole loans or packaging and marketing portfolios of loans.

And I would suggest that the financial advisers and securities attorneys for these offerings schedule pre-filing conferences with the Commission's staff by June 30. If they come in and have the documentation and the paper work in good form by June 30 they should be able to readily meet the September 30 deadline for these sales, either privately or through registered public offerings.

Thank you. It is requested that the Commission's written statement be included in the record.

Chairman CHILES. Without objection. Thank you, sir.

[The prepared statement of Mr. Shad follows:]

STATEMENT OF JOHN SHAD,
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE SENATE COMMITTEE ON THE BUDGET

CONCERNING SECURITIES LAW ASPECTS OF
FEDERAL GOVERNMENT LOAN SALES

February 19, 1987

Chairman Chiles and Members of the Committee:

I. INTRODUCTION

The Securities and Exchange Commission is pleased to testify about the applicability of the federal securities laws to the sale of the federal government loan assets mandated by the Omnibus Budget Reconciliation Act of 1986.

The principal purposes of the federal securities laws are to protect investors and to maintain fair and orderly securities markets. How the securities laws may apply to the loan sales depends upon how the transactions are structured and consummated.

The Commission staff is prepared to cooperate and assist the agencies in selling their loans in compliance with the federal securities laws. If an offering requires registration and the registration statement is well prepared by experienced securities attorneys, it should be possible for the registration statement to become effective within thirty days after filing. If the registration statement requires major modifications, it will depend upon how long it takes the issuer to provide the requisite information summarized herein. Possible exemptions from registration and some of the advantages of registration are also summarized herein.

II. BACKGROUND

The President's Budget for Fiscal 1987 proposed a pilot program to sell portions of 13 federal government loan portfolios. The program was proposed as part of the federal effort to reach the Gramm-Rudman-Hollings FY 1987 deficit target of no more than \$144 billion.

On July 8, 1986, the Office of Management and Budget issued guidelines, developed by the Federal Credit Policy Working Group, for agencies to follow in selling loan assets. The guidelines provide that loan asset sales shall be made without future recourse to the federal government, loans of tax-exempt entities shall be sold only if the future interest payments on the loans are subject to federal income tax, and collection and servicing shall be transferred to the private sector. Additionally, the guidelines provide that, in limited circumstances, agencies may offer certain borrowers that are current the right to purchase their loans. The guidelines also provide that the timing of the sales, the composition and size of loan pools, and other "marketing issues", shall be handled individually by each agency and will vary from portfolio to portfolio depending on market conditions.

On October 21, 1986, the Omnibus Budget Reconciliation Act of 1986 was signed into law. The Act adopted the loan asset sales program proposed in the President's Budget for Fiscal 1987,

with certain modifications. Modifications to the President's proposal included the specific portfolios to be sold, the fiscal years during which the portfolios are to be sold, and the amounts to be realized through the sales. The Act mandates that, under such terms as the agencies selling the loans may prescribe, certain agencies must sell portions of their loan portfolios sufficient to raise a combined total of approximately \$5 billion in FY 1987. Pursuant to this legislation, the following agencies must net the following approximate amounts during Fiscal 1987: the Farmers Home Administration ("FmHA") \$1 billion from loans of the Rural Development Insurance Fund it administers and \$1.7 billion from its rural housing fund loans; the Department of Education ("DOEd") \$579 million from its college housing loans; the Export-Import Bank \$1.5 billion from its loans; and the Economic Development Administration \$50 million from its loans. The OMB guidelines provide these agencies guidance in effecting the loan sales.

The President's Fiscal 1988 Budget recommends loan sales in FY 1988 that OMB has estimated will produce receipts of \$5.3 billion to the government. The loans would be sold from the portfolios of the following agencies: the FmHA; the DOEd; the Rural Electrification Administration; the Small Business Administration; the Department of Housing and Urban Development; the Veterans Administration; the Export-Import Bank; the Bureau of Reclamation; the Department of Health and Human Services; the Department of Transportation; and the Tennessee Valley Authority. The loan sales would be part of the federal effort to reach the Gramm-Rudman-Hollings FY 1988 deficit target of \$108 billion.

III. METHODS OF STRUCTURING SALES UNDER CONSIDERATION

The Omnibus Budget Reconciliation Act does not prescribe precisely which agency loans are to be sold or the manner in which the sales are to be made. Each agency may, consistent with the OMB guidelines, select those loans it proposes to sell from the portfolios specified by Congress and determine the most appropriate means of structuring the sales. In accordance with the OMB guidelines, both the FmHA and the DOEd have, through a competitive process, selected financial advisors on the sales.

The Commission's staff has had preliminary discussions with the FmHA regarding plans under consideration for the sale of loans from its Rural Development Insurance Fund to local governmental units and certain not-for-profit organizations such as farm cooperatives. Under a Request for Proposals ("RFP") dated December 15, 1986, the FmHA has sought proposals from prospective underwriters or purchasers of such loans. The RFP seeks specific proposals on how best to structure the sales and a marketing plan which "[m]aximizes the price paid to the federal government, and [which] [m]ay be fully and easily replicated in future sales." The RFP clarifies that the FmHA will select rural development loans for sale by random selection. */

*/ The size and nature of the loans is likely to have a significant impact on how loan sales are structured. According to a preliminary portfolio analysis prepared for the FmHA in November 1986, approximately 42% of its rural development loans are less than \$100,000, approximately 43% are \$100,000 to \$499,999, approximately 9% are \$500,000 to \$999,999, and approximately 6% are \$1 million or more.

The Commission's staff also has had preliminary discussions with the DOEd regarding that agency's proposed sales of loans from its college housing loan portfolio. */ These loans to colleges were for the construction of student and faculty housing.

FmHA and DOEd representatives have advised the Commission's staff that they are considering the sale of "whole" and of "pooled" loans. **/ In a "whole" loan sale, a particular loan or package of loans would be sold outright to purchasers. In a "pooled" loan sale, interests in a pool of such loans would be sold to the purchasers. The FmHA has considered selling pooled loans through a separate entity whose assets would consist of the loan portfolio. This entity would take the form of a grantor

*/ According to the DOEd, a July 1986 asset evaluation determined that the average size of the dormitory loans in the college housing loan portfolio is \$709,164. There are 3,076 loans in the portfolio, which were made to a total of 1,172 schools.

**/ The Commission's staff has not been apprised of plans for structuring loan assets sales that may be under consideration by the Economic Development Administration or the Export-Import Bank. The Reconciliation Act specifically amended the Export-Import Bank Act to define the sale of Export-Import Bank loans as a sale of exempted securities within the meaning of Section 3(a)(2) of the Securities Act and Section 3(a)(12) of the Securities Exchange Act. However, the Reconciliation Act provides that the Export-Import Bank shall file with the Commission such annual and other reports regarding these securities as the Commission deems appropriate in view of the nature of the Bank and as necessary in the public interest or for the protection of investors. The Reconciliation Act does not provide an exemption from the provisions of the Investment Company Act of 1940.

trust or a single-purpose finance corporation. Under a grantor trust, purchasers would be sold undivided interests in the form of equity certificates of participation in the trust, or debt obligations of the trust. Under the single-purpose finance corporation approach, the entity would purchase a portfolio of FmHA loans and would sell its own equity or debt securities to investors.

IV. APPLICATION OF THE SECURITIES LAWS

The manner in which loan sales are structured and sold will determine the extent to which the sales are governed by the federal securities laws. The following discussion generally describes how the relevant securities laws may apply to the sales currently under consideration by the FmHA and the DOEd.

SECURITIES ACT OF 1933

General

The Securities Act of 1933 has two objectives: to provide full and fair disclosure concerning securities sold to the public, and to prevent fraud in the sale of such securities. The Securities Act requires that nonexempt offerings of securities to the public be registered with the Commission. The registration statement must contain specified information about the securities being offered, the issuer of the securities and the manner in which the securities will be distributed. No sale of registered securities may be completed prior to the registration statement becoming

effective, or prior to the delivery of a prospectus to the purchaser that contains the basic information included in the registration statement.

The Securities Act imposes civil and criminal liabilities for material misstatements or omissions in the registration statement or prospectus. There also are general antifraud provisions -- enforceable by injunction and criminal sanctions, as well as private lawsuits for damages -- that apply whenever a security is sold, whether or not sold pursuant to a registration statement. The civil remedies under the Securities Act may be enforced through Commission action or by private rights of action. */ Private suits are a large multiple of Commission enforcement actions.

Not all sales of securities require registration under the Securities Act. Certain kinds of securities **/ and certain

*/ Private rights of action have been judicially implied under the general antifraud provisions of the securities laws. The ability of a purchaser of exempt securities to bring a private action against the seller of those securities under one of the Securities Act's express rights of action is limited in one regard. Section 12(2) of the Securities Act, which expressly creates a private right of action for false or misleading statements by a seller, includes an exemption for securities issued or guaranteed by such entities as federal and state governments and certain banks.

**/ These include federal and state government and municipal securities, certain bank securities and securities guaranteed by certain banks, commercial paper, and securities of issuers operated exclusively for religious, educational, benevolent, fraternal, charitable or reformatory purposes.

transactions involving securities */ are exempt from the federal registration requirements. **/ Sales of those securities, however, remain subject to the general antifraud provisions of the Securities Act. The statute does not provide the Commission with authority to exempt particular offerings from the registration requirements.

Cost-Benefit Considerations of Registration

Generally, the costs of a registered underwritten public offering will be greater and the process may take longer than a non-registered best-efforts private placement of securities with institutional investors. However, these costs may be more than offset by the benefits of registration, including the possibility of a higher price for the securities. Registration permits a broad public distribution to a greater number and range of institutional and individual investors, and the creation of an active secondary market in the securities. Further, it is common in unregistered private placements for institutional investors to require similar and sometimes more information than that required in a registration statement, more stringent terms and a lower price, justified in part by the lack of liquidity (i.e., investors cannot subsequently sell unregistered securities on the open

*/ These include intrastate offerings, private offerings and exchange offers of one security of an issuer for another security of the same issuer.

**/ Even though exempt from federal registration requirements, such offerings may be subject to the registration requirements of one or more states.

market). */ All other things being equal, illiquid securities may sell at a 10% or larger discount from the price of liquid securities. Such a discount would significantly exceed the greater cost of a registered offering. Also, compliance with the registration requirements facilitates comparative analysis of the securities offered with already publicly traded issues.

It is, therefore, desirable for the financial advisors and legal counsels to the agencies to analyze carefully the size and nature of each financing, the quality of the loans to be sold and current market conditions in order to determine whether a registered public offering, a non-registered private placement or a combination of both, is the most advantageous means of selling large whole loans or packaging and marketing a portfolio of loans.

Application of the Securities Act
to Proposed Loan Sales

Two approaches under consideration are the sale of individual or packages of loans, and the sale of participations or interests in pooled loans, either through a grantor trust or a single-purpose finance corporation.

*/ In addition, in private placements, institutional investors commonly require periodic reports sometimes containing different but more information than that required under the Securities Exchange Act of 1934, which is discussed below.

The direct sale of loans would not appear to involve the sale of a "security" as defined under the Securities Act, and would not be subject to any of its provisions. While the definition of security in the Act includes the terms "any note" and "evidence of indebtedness", in recent years the courts have begun to distinguish between loans for "investment" purposes and those for "commercial" purposes. */ No single test has evolved, but generally the courts focus on the context in which the loan is made. Loans by government agencies to facilitate the construction of college dormitories, or to assist rural communities with local projects, are likely to be treated as "commercial" rather than "investment" loans, and therefore, the loans would not be deemed "securities." **/ However, if the sales were

*/ Although applying doctrines with different names, all courts addressing the issue have recognized that many forms of ordinary lending are not notes or evidences of indebtedness intended to be covered by the registration and antifraud provisions of the Securities Act. The most widely accepted of these doctrines is called the commercial-investment test. The tests in all courts appear to operate principally through application of illustration and analogy rather than definition. Consumer loans and home mortgages are frequently-used examples of debt outside the definition of securities. Bank borrowings, including debt incurred for business purposes, are similarly regarded unless the particular form of debt has sufficient characteristics ordinarily associated with securities sold to the public. Exchange National Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976).

**/ A question that the courts have not considered is whether the circumstances of any later sales of those loans to third parties could cause the later sales to be treated as sales of securities. The resolution of this issue, however, would not affect the analysis applicable to the original sale of loans by the agencies.

effected through a broad public distribution of interests in such loans, they would be subject to the securities laws.

In addition, interests or participations in pools of such loans, whether in the form of equity or debt, would constitute "securities" under the Securities Act. The sale of such interests or participations would require registration with the Commission unless an exemption applies. The status of the entity issuing the participation or interest as a grantor trust or a single-purpose finance corporation does not affect this conclusion.

Possible Exemptions from Registration

Preliminary discussions with representatives of the FmHA and the DOEd concerning their proposed sales have identified three possible statutory exemptions from registration under the Securities Act, those contained in Sections 3(a)(2), 3(a)(4) and 4(2). In addition, certain foreign offerings do not require registration.

Section 3(a)(2)

Section 3(a)(2) provides an exemption for any security "issued or guaranteed by the United States . . . or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States" This exemption would be available if the entity issuing the interests or participations was formed or sponsored by the federal government or the agency selling the loans, and there was recourse to the government

or agency, or if the federal government or agency guaranteed the interests or participations. Since OMB's guidelines provide that all sales must be made without future recourse to the federal government, it does not appear that this exemption would be available.

Section 3(a)(2) also exempts from registration any security guaranteed by "any national bank, or any banking institution organized under the laws of any State, Territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official." The Commission's staff has treated standby letters of credit as guarantees by a bank. Therefore, if the participations or interests in the loan pools were backed by such a bank letter of credit, the Section 3(a)(2) exemption would be available. */

However, in the event of a default on a bank guaranteed security, the bank might encounter financial difficulties in honoring its guarantee and be taken over by the Federal Deposit Insurance Corporation. The FDIC is funded by its member banks, but has ultimate recourse to the U.S. Treasury. Therefore, guarantees by ~~FDIC member banks~~ appear to be prohibited under the

*/ It should be noted, however, that the Investment Company Act of 1940 discussed below does not contain a corresponding exemption from its registration requirements for companies holding securities backed by bank guarantees.

OMB guidelines. Guarantees by banks not insured by federal agencies may permit exemption from registration.

Section 3(a)(4)

Alternatively, it has been suggested that Section 3(a)(4) may permit exemption from registration, if a single-purpose corporation established to sell participations in the pooled loans were set up as a tax exempt corporation under Section 501(c)(3) of the Internal Revenue Code. Section 3(a)(4) exempts securities issued by "a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the earnings of which inures to the benefit of any person, private shareholder, or individual." The Commission's staff does not have details of a specific proposal at this time, but it appears that this approach would render the United States Government the beneficiary of the tax exempt corporation's charitable activities.

The staff has not previously considered the applicability of the Section 3(a)(4) exemption to instruments similar to the proposal discussed above. However, this exemption has been unavailable to securities of entities organized and operated for tax exempt purposes when there exists a single, substantial nonexempt purpose being served by an otherwise exempt issuer. The flow of the proceeds from the proposed loan sales to the

government would not appear to constitute a "charitable" purpose within the meaning heretofore given to this exemption. Accordingly, this exemption may not be available.

Section 4(2)

Section 4(2) also has been suggested as a possible exemption. Section 4(2) exempts "transactions by an issuer not involving any public offering." Whether a particular offer and sale constitutes a private placement involves issues of fact and law. The basic principle is that the exemption is available only for a limited offering to investors who have financial knowledge and experience. Whether an investor has such knowledge and experience depends, in part, on that investor's access to the same kind of information as would be included in a registration statement, and on the sophistication of the person. Generally, an offering will be exempt so long as the offerees have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the investment.

In 1982, the Commission adopted Rule 506 in order to provide some objective standards for the availability of the Section 4(2) exemption. Generally, an offering is exempt under Rule 506 if it meets the following tests:

1. Neither general advertising nor solicitation is permitted.

2. a. All of the purchasers are "accredited investors," */
or
b. If there are non-accredited investors, the issuer furnishes all of the purchasers the same kind of information that registration would require.
3. The purchasers may not include more than 35 non-accredited investors.
4. A report on Form D must be filed with the Commission. Form D is an eight-page form which provides notification to the Commission of sales of securities pursuant to the Regulation D exemption.

A sale of interests or participations in government loans that would come within Section 4(2) or the safe harbor provided by Rule 506 would generally involve large denominations (\$100,000 or more), institutional investors (banks, insurance companies, pension funds) and no general advertising. Sales would not be exempt if they involve large numbers of non-accredited investors, advertising or other public solicitation of potential investors.

*/ Section 2(15) of the Securities Act and the Commission's related rules define the term "accredited investor" to include banks, insurance companies and private business development companies, certain employee benefit plans and tax-exempt organizations, and natural persons whose net worth or income indicates risk-bearing ability.

Foreign Sales

Interests or participations could also be sold without registration outside the United States to foreign investors. The Commission generally will not take action for failure to register such offerings. Because the registration requirements of the Securities Act are intended primarily to protect American investors, the Commission has found registration of securities of United States issuers distributed abroad to foreign nationals unnecessary as a policy matter so long as the offering is made in a manner designed to assure that the securities "come to rest" abroad.

Registration of Participations and Interests Under the Securities Act

If no exemption is available, registration under the Securities Act would be required. */ And even if an exemption is available, an issuer is not precluded from registering securities with the Commission if it wishes to do so. Although sales of pooled government agency loans would involve a new security, and the

*/ If the security issued by the grantor trust or single-purpose finance corporation is a debt security, the issuer would have to comply with the Trust Indenture Act of 1939 in addition to the Securities Act. The purpose of the Trust Indenture Act is to provide for an independent trustee to protect and enforce the rights of the holders of the securities. The Trust Indenture Act requires the filing of a contract, the indenture, which specifies the duties of the trustee and sets forth standards to assure the independence of the trustee. Once the indenture is qualified at the time the registration statement becomes effective, the Commission has no enforcement powers under this statute.

agencies have not finalized their plans for selling their individual securities, the Commission's staff has had experience processing registration statements for products that may be similar to those proposed by the agencies. For approximately ten years, issuers have been filing registration statements relating to securities backed by portfolios of mortgages. In FY 1986, for example, registration statements for Collateralized Mortgage Obligations ("CMO's") totaled over \$80 billion. In recent years registration statements securitizing other forms of debt obligations have been filed. */ Some of these registration statements are filed by the company that originates the mortgage or other asset included in the pool. More typically, however, the registration statement is filed by a sponsor, often an investment banker, that purchases the mortgages or other assets from the originator or in the open market and sells a separate security backed by the pooled assets to the public.

Where the entity issuing the security is a grantor trust selling pass-through equity certificates or mortgage-backed bonds, the registration statement is normally filed by the sponsor on behalf of the trust to be formed. If the issuing entity is a single-purpose corporation formed as a wholly-owned subsidiary of the sponsor, that corporation signs the registration statement.

*/ Examples include securities backed by automobile receivables, credit card receivables and lease receivables.

In either case the sponsor would be liable for any materially false or misleading statements in the registration statement. Liability arises in the first case because the sponsor signs the registration statement, and in the second case because the sponsor is in control of the single-purpose corporation. */ In those cases where the security is sold to the public by the sponsor, the role of the originator **/ of the mortgages or other assets would end upon sale of the assets to the sponsor, and the originator ordinarily would not be liable under the securities laws for violations in connection with the sale of the security. However, the originator (i.e., agency) may of course be civilly liable to the sponsor for fraud or under any of the representations, warranties, or other terms and conditions that survive the sale to the sponsor.

Depending on how the sales are ultimately structured, the content of any registration statement for the sale of pooled government agency loans may be similar to the content of those filed in connection with other asset-backed securities. In the case of the sponsor signing the registration statement on

*/ Section 15 of the Securities Act makes controlling persons of individuals or entities found liable under the Act jointly and severally liable for the controlled persons' actions.

**/ In the case of the pooled loan sales, the government agency would be the originator.

behalf of grantor trusts to be formed, the sponsor would be identified and information concerning its activities on behalf of the trust would be provided. Because an investor's interest would be limited to the assets placed in the trust, additional information about the sponsor/issuer, including its financial statements, would not be required. In the case of a single-purpose corporation, information about the corporation would be required. If the corporation was newly formed it would have only a limited organizational history, and the information required would not be extensive. The financial statements would be limited to a balance sheet showing the capital contributed at the time the corporation was formed. In either case because the trust or corporation would be responsible for future servicing of the pool of assets, complete disclosure of its duties and responsibilities for that function would be required.

The bulk of the disclosure in the registration statement would involve information concerning the loans used to collateralize the securities being offered. Assuming that (a) no individual loan is significant to the pool as a whole and (b) the pooled loans are relatively homogeneous in terms, payment schedule, etc., the following indicates the type of information that would be required. */

*/ If the pooled loans are not homogeneous, then additional information would be required.

1. General terms of the contracts that create the loans, or the parameters of the loan terms, including, but not limited to:
 - a. the terms of payment,
 - b. the collateral,
 - c. recourse, and
 - d. obligor options.
2. Nature of any credit analyses prior to making the loans.
3. Delinquency and loss experience, by number of loans and dollar amount, for:
 - a. the type of loans in the pool,
 - b. loans meeting the criteria for inclusion in the pool, and
 - c. loans transferred into the pool.
4. Criteria for selecting loans to be included in the pool.
5. Loans included in the pool (grouped in ranges, weighted averages, or both depending on characteristics and range of terms), by number of loans and dollar amount:
 - a. date of origination, remaining life,
 - b. interest rate,
 - c. the number of loans, average size,
 - d. geographic distribution,
 - e. original amount and remaining balance, and

- f. original amount of the loans as a percentage of the value of the collateral.
- 6. Perfected security interests in the collateral.
- 7. Prepayment experience.
- 8. Any loan documentation problems.

SECURITIES EXCHANGE ACT OF 1934

Issuers of participations and interests evidencing pooled loans may also be subject to the Securities Exchange Act of 1934. */ The primary effect of the Exchange Act is to require periodic disclosure pursuant to Sections 13(a) and 15(d) of that Act. **/

Issuers selling securities pursuant to a Securities Act registration statement are required under Section 15(d) of the Exchange Act to file such periodic reports as would be required under Section 13(a) for the fiscal year in which the registration statement became effective, and for each subsequent year if they have 300 or more holders of the registered securities at the start of the fiscal year. ***/

*/ In addition, in private placements, institutional investors commonly require periodic reports sometimes containing different but more information than that required under the Securities Exchange Act of 1934.

**/ Section 13(a) requires issuers with a class of securities registered under Section 12 to file annual and other reports as prescribed by the Commission's rules.

***/ Issuers that have total assets of more than \$5,000,000 and equity securities held by more than 500 persons at any

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The periodic reporting requirements include a Form 10-K annual report disclosing the issuer's business, properties and financial condition. In the case of pooled asset vehicles, the report normally would include specific information with respect to the assets included in the pool, and other information similar to that required in the initial Securities Act registration statement.

In addition, Sections 15(d) and 13(a) require subject issuers to file interim quarterly reports on Form 10-Q. The principal content of Form 10-Q is unaudited quarterly financial information. Finally, from time to time issuers must also file reports on Form 8-K, generally within 15 days after the occurrence of certain reportable events. */

(Footnote Continued)

fiscal year end must register the class of securities under Section 12(g) of the Exchange Act. Registration under Section 12(g) would result in the issuer's being subject to additional provisions of the Exchange Act, including the Commission's proxy rules under Section 14, and the insider trading requirements adopted under Section 16. Section 16 requires reports of acquisitions and dispositions of equity securities held by officers, directors and holders of 10% or more of such securities, and imposes liability on the persons required to report for purchases and sales or sales and purchases made within a six-month period.

*/ Reportable events are changes in control, acquisition or disposition of material amounts of assets, bankruptcy or receivership, changes in accountants and resignations of directors. Financial statements are required for certain acquisitions or dispositions of assets.

Section 12(h) of the Exchange Act authorizes the Commission to exempt an issuer, in whole or in part, from its obligations under Section 13(a) to file periodic reports. In the case of trusts issuing mortgage pass-through certificates, the Commission's staff, acting pursuant to delegated authority, has granted some relief from the required reporting regulations. These issuers have been permitted to file abbreviated Form 10-K annual reports and to discontinue filing Form 10-Q reports. Instead, such issuers file monthly reports under cover of Form 8-K in which the trustees provide information concerning the assets held in trust. This procedure significantly reduces the cost of the periodic reporting. Similar treatment could be accorded issuers structured to offer pass-through securities backed by government agency loans.

INVESTMENT COMPANY ACT OF 1940

Congress enacted the Investment Company Act of 1940 to address abuses associated with companies whose assets consist primarily of securities. These abuses included the failure to provide adequate information to shareholders; the management of investment companies in the interest of persons other than their shareholders; the issuance of securities containing inequitable or discriminatory provisions; the undue concentration or inequitable distribution of control; the use of unsound or misleading methods of keeping accounts and computing earnings

and asset values; the change of the character or control of the business without shareholder consent; excessive borrowing and issuance of excessive amounts of senior securities, resulting in unduly speculative junior securities; and inadequate assets or reserves.

The Investment Company Act applies to issuers engaging primarily in the business of investing, reinvesting, owning, holding, or trading in securities. It excludes from its scope operating companies, and holding companies engaged in industrial operations through subsidiaries. The statute generally distinguishes between two types of registered investment companies -- the unit investment trust and the management company. A unit investment trust offers redeemable interests in a fixed portfolio of securities and does not have a board of directors or portfolio managers. Management companies offer interests in a managed portfolio of securities and usually have boards of directors. Management companies can be either open-end or closed-end. Only an open-end management company -- also called a "mutual fund" -- offers redeemable securities, giving the holder of the security the right to receive approximately a proportionate share of the issuer's current net assets upon presentation of the security to the issuer.

The Investment Company Act requires a non-exempt investment company to file a registration statement with the Commission.

The statute imposes substantive and rigorous restrictions on the structure, operations and activities of registered investment companies designed to prevent the abuses that led to its enactment. Examples of these restrictions include:

1. Transactions involving persons affiliated with the investment company or its investment adviser are generally prohibited, absent prior Commission authorization or compliance with conditions of Commission rules.
2. Pyramiding of capital structure resulting from issuing multiple classes of securities and speculative investment practices are prohibited or restricted.
3. Persons guilty of securities violations or barred from the securities business are prohibited from employment by, or providing services to, the investment company.
4. Various fiduciary duties are imposed on companies and persons managing investment companies.
5. Sales and distribution practices are restricted except as permitted by Commission rule.
6. Assets are subject to strict custodial requirements, and specific amounts of fidelity insurance must be maintained.
7. Periodic reports must be sent to shareholders and filed with the Commission.

8. Specified books and records must be maintained and are periodically inspected by the Commission's staff.
9. Advisory contracts must be approved by shareholders.

The Investment Company Act imposes civil and criminal liabilities for violations of its provisions. The Commission may obtain injunctive and administrative relief. The statute also includes an express private right of action for recovery of excessive advisory fees.

The Investment Company Act includes numerous exemptions from its requirements, mainly in the form of exceptions to the statutory definition of an investment company. */ In addition, the statute provides the Commission with exemptive authority.

Cost-Benefit Considerations of Registration

The costs of registration under the Investment Company Act are not significantly greater than the costs of registering under the Securities Act, since Commission rules permit issuers to file one registration statement under both statutes. The substantive regulations under the Investment Company Act may

*/ Section 3(c) of the Investment Company Act expressly exempts from the definition of investment company thirteen types of entities that otherwise would be subject to the Act. Exempt entities include charitable, small loan, private investment, and sales finance companies, and companies holding real estate interests. These statutory exemptions are based on such considerations as the nature of the offeror, the number and nature of security holders, and characteristics of the securities issued.

entail some additional direct or indirect costs. However, these costs may be offset by the tax benefits associated with Investment Company Act registration. */ Under the Internal Revenue Code, most investment companies that register under the Investment Company Act can qualify as "regulated investment companies." These companies are not subject to separate federal corporate income tax. Distributions of dividends or interest received, and of capital gains realized, are subject only to federal tax payable by the company's shareholders, as if the shareholders held the investment company's portfolio securities directly. **/

Registration under the Investment Company Act would also facilitate compliance with the OMB guidelines governing the loan sales, which require that future interest payments on any loans of tax-exempt entities be subject to federal income tax. The Internal Revenue Code permits regulated investment companies to choose whether to distribute tax-exempt income to shareholders as tax-exempt dividends or as taxable dividends.

*/ Depending on the manner in which the pooled loans are structured, exemptive relief from certain provisions of the Investment Company Act may be required in order to achieve registered investment company status.

**/ The Tax Reform Act of 1986 also created tax flow-through benefits for any entity that qualifies for treatment as a Real Estate Mortgage Investment Conduit ("REMIC"). In general, a REMIC is defined as an entity consisting substantially of a fixed pool of mortgages secured by interest in real property that issues multiple classes of securities to investors. Depending on the nature of the loans involved, these provisions may provide an alternative method for some loan sales to achieve favorable tax treatment.

Application of the Investment Company
Act to Proposed Loan Sale Methods

Section 3(a)(1) of the Investment Company Act defines the term "investment company" to include any issuer that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities, and Section 3(a)(3) defines investment company to include any issuer that "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis."

The sale directly to the public of whole loans or packages of whole loans would not involve the creation of an investment company. Therefore, such sales would not be subject to the Investment Company Act.

The sale of debt or equity interests in a pool of government loans would result in the creation of an "investment company" as defined by the statute. */ Although the loans in which the entity

*/ This is so whether the entity issuing the interests takes the form of a grantor trust or a single-purpose finance corporation. Since the vehicles have not yet been structured, it has not yet been determined whether any sales vehicles proposed by the FmHA or the DOE that would register under the statute as investment companies would be classified as unit investment trusts or management companies.

would invest are not themselves "securities" for purposes of the Securities Act, courts have construed the term "securities" as used in the Investment Company Act to include such instruments. Therefore, the sale of interests or participations in a pool of loans would require compliance with the requirements of the Investment Company Act, unless a statutory exemption from the definition of investment company applies or exemptive relief from all or some of the statute's requirements is granted.

Possible Statutory Exemptions from
the Investment Company Act

During preliminary discussions with representatives of the FmHA and the DOEd, the nature of the loans and the possible exemptions from the Investment Company Act have been discussed. Based on those discussions and the Commission staff's preliminary understanding of the loans to be sold, exemptions contained in Sections 2(b), 3(c)(1), 3(c)(5)(A), 3(c)(5)(C), and 3(c)(10) of the Investment Company Act appear to be most relevant.

Section 2(b)

Section 2(b) makes the statute inapplicable to "the United States, . . . or any agency, authority, or instrumentality . . . or any corporation which is wholly owned directly or indirectly by [the U.S.]" As noted, a similar exemption for government securities exists in the Securities Act. However, the Investment Company Act exemption is more limited.

Issues to be considered in determining the availability of this exemption are the existence of a guarantee by the government and the relationship of the issuer to the government. If any sales by the FmHA or the DOEd will be made by an entity independent of the government or any agency, and without recourse to the federal government, the Section 2(b) exemption would not appear to be available.

Section 3(c)(1)

Section 3(c)(1) is the counterpart to the private offering exemption in Section 4(2) of the Securities Act. Its purpose is to exclude privately held investment companies from the operation of the Act.

Section 3(c)(1) has two basic requirements: that the securities not be issued to more than 100 "beneficial owners," and that the issuer not make -- or presently propose to make -- a public offering of its securities. Important issues in analyzing the availability of this section include determining who is a beneficial owner; what constitutes a "public offering;" */ and what plans the issuer may have for future offerings. At least some loan sales could be structured to come within this exemption.

*/ The private offering exemption under the Investment Company Act has been construed differently from that under the Securities Act. For example, compliance with Regulation D under the Securities Act would not necessarily satisfy the requirements under the Investment Company Act.

Sections 3(c)(5)(A) and 3(c)(5)(C)

The exemptions in Sections 3(c)(5)(A) and 3(c)(5)(C) are available to issuers that are not issuing "redeemable" securities and are "primarily engaged in" specified businesses. Section 3(c)(5)(A) concerns businesses involved in acquiring obligations representing part or all of the sales price of merchandise, insurance and services. The legislative history of Section 3(c)(5)(A) reveals that the provision was intended to encompass the business of buying or dealing in "automobile paper or refrigerator paper" or other "small loans." Therefore, it is unlikely to be available to issuers participating in the government loan sales program.

Section 3(c)(5)(C) concerns businesses involved in purchasing mortgages and other liens on or interests in real estate. The two issues important in determining the availability of Section 3(c)(5)(C) are the interpretation of the terms "redeemable securities" and "primarily engaged," which have been analyzed by the staff in a wide variety of situations. For example, "redeemable securities" include securities redeemable upon 30 days notice, or by a third party acting as agent for the issuer. Staff interpretations state that an issuer meets the "primarily engaged" requirement if at least 55% of its assets consist of mortgages, or liens on, or interests in real estate. The remaining 45% must consist primarily of real estate related investments.

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Examples of interests in real estate include: fee interests, leaseholds, a note fully secured by a mortgage solely on real estate, and GNMA, FNMA or FHLMC certificates comprising an undivided interest in the entire pool of mortgages backing the certificates ("whole pools"). Examples of real estate related investments include GNMA, FNMA or FHLMC certificates comprising a proportionate interest in the entire pool of mortgages backing the certificates ("partial pools"), and a limited partnership primarily engaged in acquiring and owning interests in real estate. Because the underlying collateral supporting the government loan obligations to be sold has not yet been fully identified, it is not possible at this time to determine whether the Section 3(c)(5)(C) exemption would be available for government loan sales.

Section 3(c)(10)

Section 3(c)(10) is the counterpart to Section 3(a)(4) of the Securities Act. It provides an exemption for any not-for-profit company "organized and operated exclusively for religious, educational, benevolent, paternal, charitable, or reformatory purposes." During initial discussions with representatives of the DOE, they suggested that a not-for-profit charitable corporation could be established as the issuer of the participation interests, with the government as the "beneficiary." It would not appear, however, that the flow of the proceeds from the proposed loan sales to the government would constitute a "charitable" purpose as envisioned under Section 3(c)(10).

Additionally, according to staff interpretations, the entity seeking the exemption must first obtain a letter ruling from the Internal Revenue Service that it qualifies for a tax exemption under Section 501(c)(3) of the Internal Revenue Code. The entity must maintain its tax exempt status, or its exemption under the Investment Company Act will lapse.

General Exemptive Authority Under
The Investment Company Act

Finally, the Commission has authority, by order or rule, to grant exemptions from all or specific provisions of the Investment Company Act. Section 6(c) permits the Commission to exempt any person or transaction from any or all provisions of the Investment Company Act if the exemption is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act. */ The statute requires that the Commission consider all of the terms and circumstances of the offering when it determines whether to grant exemptive relief under Section 6(c). The Commission grants exemptions on a fact-specific basis. Exemptive orders often contain precise conditions to ensure that the requirements of Section 6(c) are met. For example, the Commission has

*/ This provision was discussed during Senate consideration of the Reconciliation Act. Congressional Record S16972, (daily ed. Oct. 17, 1986) (statement of Senator Helms).

granted issuers of CMO's exemptions from all provisions of the Investment Company Act, in situations where the CMO's will be issued in compliance with the Securities Act, the substitution of mortgage collateral is limited in kind and amount to that specified in the original offering, the collateral is held by an independent trustee or custodian, the bonds have a high quality rating by an independent rating agency, and the issuer is audited annually.

V. CONCLUSION

The manner in which loan sales required by the Omnibus Budget Reconciliation Act are structured and consummated will determine whether the sales are governed by the federal securities laws. At this time, the agencies subject to the loan sale requirement have not determined what form the loan sales will take. The Commission's staff is prepared to work with the agencies to resolve questions as to how the securities laws would apply to specific proposals and what exemptions, if any, are needed or appropriate.

As indicated on pages 8-9 and 26-27, there may be price or other advantages in effecting loan sales through registered public offerings, rather than unregistered private placements or other exempt transactions, and in registering the loan pools as investment companies. It is, therefore, desirable for the financial advisors and legal counsels to the agencies to analyze carefully the size and nature of each financing, the quality of the loans to be sold and current market conditions in order to determine the most advantageous means of selling large whole loans or packaging and marketing a portfolio of loans.

Chairman CHILES. Dr. Feldstein.

STATEMENT OF DR. MARTIN FELDSTEIN, HARVARD UNIVERSITY
AND NATIONAL BUREAU OF ECONOMIC RESEARCH

Dr. FELDSTEIN. Thank you very much, Mr. Chairman. I am certainly pleased to be back before this committee and to discuss the sale of Federal assets as a technique of deficit reduction. I understand fully the political temptation to rely on asset sales as a means of reducing the budget deficit in meeting the Gramm-Rudman-Hollings targets instead of the more painful process of cutting spending or raising revenue through tax increases and use charges. But asset sales actually do nothing to reduce the real Federal deficit. Although the official Government accounting rules treat the revenue raised by asset sales as equivalent to increased tax receipts or reduced spending outlays, that is simply a weakness of our government accounting rules.

ASSET SALES HAVE NO EFFECT ON CREDIT MARKETS

Asset sales do not reduce the demands of the Federal Government on our Nation's credit markets. And unlike reduced Government spending or higher taxes, asset sales do not increase our national saving rate and the resources available for new investments in plant and equipment and in housing. That is why even though asset sales reduce the budget deficit as defined for Gramm-Rudman-Hollings purposes it does not change the national income account budget deficit.

The sale of Government assets has essentially the same effect on our credit markets and on our national economy as the sale of an equal amount of Government bonds. To treat asset sales as meaningful deficit reduction is simply phoney accounting.

Indeed, since the term deficit has a very specific meaning defined by Government accounting rules, I think it would be helpful if we referred to the difference between the Government's outlays and its revenue from taxes and user charges not as the deficit but as "credit needs." These credit needs can be met either by selling old assets or new Government bonds. It really is irrelevant in terms of economic impact.

It is easy enough to see why asset sales do nothing to offset the current excess of Federal spending over tax revenue. That is, they do nothing to change the Government's basic credit needs. The essential impact of the Federal deficit is to crowd out private investment. The Government spends more than it takes in tax revenue. The bonds that the Government issues to pay for this must be absorbed in private portfolios.

Now, Government asset sales crowd out new private investment in exactly the same way as the Government's sale of Treasury bonds. If the Government sells existing loans or other assets, the resulting securities will displace private investment in exactly the same way as if the Government had sold more Treasury bonds. Indeed, if there is any difference at all it is that the financial markets will regard the sale of Government assets as more akin to corporate securities and will widen the spread between the borrowing

cost to corporate borrowers in the future and the cost that the Government pays on its bonds.

PROPER ACCOUNTING FOR ASSET SALES

Let me come to the issue of the proper accounting for asset sales, which I was asked about specifically in the invitation to testify today. I think the simplest procedure would in principal be to redefine the budget deficit so that it excludes these Government lending activities and the sale of Government assets.

That would preclude the sale of assets from creating a false impression about reaching actual deficit reduction, but at the same time it would also have an adverse effect of encouraging an increased volume of soft Government loans in place of current direct spending. So I think that either way we do it—either putting them on budget or off budget—is open to distortion and abuse.

Perhaps the best thing would be to maintain the current definition of the budget deficit but to restate the Gramm-Rudman-Hollings deficit reduction targets in terms of the Federal Government's credit needs; that is, to exclude the revenue from the sale of assets in calculating the deficit for Gramm-Rudman-Hollings purposes.

That would eliminate asset sales as a way of dealing with our short term deficit problem. But by keeping the traditional measure of the deficit in parallel as a central concept of the budget, we would reduce the temptation to substitute soft loans for direct spending.

Indeed, there is another possibility that occurred to me after I prepared this formal statement that I like even better. And that is to distinguish between old loans—loans that are already outstanding—and new loans. Old loans would not, under this proposal, be sold count as deficit reduction. They would be treated as a kind of off-budget activity.

But new loans would be treated as proposed in the administration's Credit Reform Act so that only the subsidy element would appear on the budget. The lending in the sale of new loans would be treated as currently proposed. I think that would have the advantage that it would correctly identify the subsidy element in new lending, but it would avoid the phoney credit for selling old loans.

ASSET SALES NOT SO DESIRABLE

Let me comment, finally, on the argument that these asset sales are desirable in themselves because they get the Government out of activities in which it does not belong, and because such asset sales do make clear the extent of the subsidy involved in existing loans. I think that is a powerful argument.

I think loan asset sales in themselves would be a good thing for getting the Government out of areas in which it should not be operating, and I would certainly applaud eliminating the Government from its current credit activities, although I believe that the proposed sale of past assets by itself would by no means stop the Government from initiating new loans under these old programs.

While it is worthwhile to have the financial markets indicate the extent of the subsidy inherent in Government loans, I think the ad-

vantage of this clarification is outweighed by the disadvantage of mis-measuring the size of the true deficit.

In short, I hope that the Congress will avoid the temptation to achieve an artificial reduction in the budget deficit by this relatively painless route of asset sales. Asset sales are simply not real deficit reductions. They do not reduce the Government's demand on the credit markets or its impact on the economy. The only meaningful way to reduce the budget deficit is the old fashioned and painful way, to spend less or tax more.

I will skip some of the prepared testimony and just leave it in the record. Thank you.

Senator LAUTENBERG [presiding]. Without objection. Thank you, sir.

[The prepared statement of Dr. Feldstein follows:]

Asset Sales Are Not Deficit Reduction

Martin Feldstein*

Testimony before the Senate Budget Committee

February 19, 1987

Thank you, Mr. Chairman. I am very pleased to appear before this committee and to discuss the sale of federal assets as a technique of deficit reduction.

I understand fully the political temptation to rely on assets sales as a means of reducing the budget deficit instead of the more painful process of cutting spending or raising revenue through tax increases and user charges. But asset sales actually do nothing to reduce the real federal deficit. Although the official government accounting rules treat the revenue raised by asset sales as equivalent to increased tax receipts or reduced spending outlays, that is simply a weakness of our government accounting rules.

Asset sales do not reduce the demands of the federal government on our nation's credit markets. And unlike reduced government spending or higher taxes, asset sales do not increase our national saving rate and the resources available for new investments in plant and equipment and in housing.

* Professor of Economics, Harvard University, and President of the National Bureau of Economic Research.

The sale of government assets has essentially the same effect on our credit markets and on our national economy as the sale of an equal amount of government bonds. To treat asset sales as meaningful deficit reduction is simply phoney accounting.

Indeed, since the term "deficit" has a specific meaning defined by the government accounting rules, I think it would be helpful if we referred to the difference between the government's outlays and its revenue from taxes and user charges as the government's "credit needs." These credit needs can be met by selling old government assets or new government bonds. For the economy and the credit markets, the choice between these two is simply irrelevant.

It is easy to see why asset sales do nothing to offset the current excess of federal spending over tax revenue, i.e., do nothing to change the government's basic credit needs. The essential impact of the federal deficit is to crowd out private investment. When the government spends more than it takes in tax revenue, the bonds that the government issues to pay for this excess must be absorbed in private portfolios. Most of the government bonds are bought by banks, by individuals, and by insurance companies, pension funds and other institutional investors. These government bonds take the places that would otherwise go to new private securities: new corporate bonds, stocks or bank loans that would finance additional investment in plant and equipment and new mortgages that would finance home building. In addition, some of the government bonds are bought

directly by manufacturing businesses and other nonfinancial firms that find the high real yields on government bonds more attractive than additional investments in their own plant and equipment.

Government asset sales crowd out new private investment in exactly the same way as the government's sale of Treasury bonds. If the government sells existing loans or other assets, the resulting securities will displace private investment in the same way as if the government had sold more Treasury bonds. If there is any difference at all, it is that the securities based on federal loans or other federal assets would, if they carry no federal government guarantee, appear to the credit markets to be more like corporate securities than government bonds and would thus tend to raise the cost of borrowing to corporate borrowers relative to the interest rate on Treasury bonds.

I've occasionally read discussions that describe asset sales as helping to reduce the budget deficit in the short run but only at the cost of a bigger deficit later. That is, of course, the way that the government accounts would reflect the asset sale: an increased cash inflow when the federal loan is sold and less future cash because the interest and principal on those loans will no longer be received by the government. But that is simply an accounting fiction with no real impact on the credit markets or the economy.

In describing the effect of government borrowing on the credit markets I have said nothing yet about the inflow of foreign capital which has become so important in recent years.

In 1986, net foreign investment in the United States was \$144 billion and accounted for a remarkable 62 percent of all net investment in the United States -- including investment in plant and equipment, the construction of new housing and the accumulation of inventories. Without this massive capital inflow, our net investment would have been less than \$100 billion because of the crowding out caused by the government's borrowing. Although the trade deficit that has inevitably accompanied the inflow of foreign capital has been very painful for our trade sensitive industries, the inflow of foreign capital has clearly been critical for maintaining our rate of net investment.

The key point about this foreign capital inflow in the context of today's discussion is that substituting the sale of government assets for the sale of government bonds would not alter any of this arithmetic. The inflow of foreign capital and the net amount of private investment in the United States will not depend on the extent to which the government uses asset sales rather than new Treasury bonds to finance its credit needs.

In your invitation to testify you asked me to comment on the proper accounting for asset sales. The simplest procedure would in principle be to redefine the budget deficit so that it excludes government lending activities and the sale of government assets. Although this would preclude the sale of assets as a means of reaching the deficit target, it would also have the adverse effect of encouraging an increased volume of government soft loans in place of current direct spending. In short, either way of measuring financial asset transactions is open to abuse.

Perhaps the best thing would be to maintain the current definition of the budget deficit but to state the Gramm-Rudman-Hollings deficit reduction target in terms of the federal government's "credit needs." This would eliminate asset sales as a way of meeting the Gramm-Rudman-Hollings targets. Keeping the traditional measure of the deficit as a central concept of the budget would reduce the temptation to substitute soft loans for direct spending.

Let me comment finally on the argument that these asset sales are desirable in themselves because they get the government out of activities in which it doesn't belong and because such asset sales would make clear the extent of the subsidy involved in the existing loans. I would certainly applaud eliminating the government from some of its current credit activities, although I believe that the proposed asset sales would by no means stop the government from initiating new loans under these old programs. And while it is worthwhile to have the financial markets indicate the extent of the subsidy inherent in the government loans, I think the advantage of this clarification is outweighed by the disadvantage of mismeasuring the size of the true deficit.

In short, I hope that the Congress will avoid the temptation to achieve an artificial reduction in the budget deficit by the relatively painless route of asset sales. Asset sales are simply not real deficit reductions. They do not reduce the government's demand on the credit markets or its impact on the economy. The only meaningful way to reduce the budget deficit is the old fashioned and painful one: spend less or tax more.

Thank you.

Senator LAUTENBERG. Mr. Greenspan, we welcome your testimony.

STATEMENT OF DR. ALAN GREENSPAN, TOWNSEND-GREENSPAN CO.

Dr. GREENSPAN. Thank you, Mr. Chairman. As always it is a privilege to appear before this committee, especially on an issue which though technical is going to create a goodly amount of conversation because it gets to the root of our basic budget policy problems.

APPROPRIATELY LABEL GOVERNMENT SERVICES

I would take a slightly different tack from that of Martin Feldstein, although I must say that I find little in what he has said with which I would disagree. Government loans have had a checkered history. They are part of a segment of Federal fiscal activities that employ a variety of different vehicles to mask direct subsidy payments from the Federal Government to specific constituents.

We see it in the Social Security System where the present value of payments into the OASI funds by both employees and employers falls short of the average present value of insured benefits, non-recourse crop price support loans simulate a market transaction when in fact they are an implicit cash subsidy. Premiums into the FDIC and certainly the FSLIC create entitlements that will almost surely prove to be significantly in excess of the present value of insurance for depositors.

The most direct evidence of the existence of hidden or partially hidden subsidies is the fact that the market value of the Federal Government's loan assets is only a fraction of reported book value. It should be a cardinal principle of budget policy that services rendered to constituents by the Federal Government be accurately labeled; a subsidy, a loan, an entitlement, and so forth.

Too much effort is expended by legislation to obscure the nature and size of payments to constituents. Budget policies of both Presidents and congressional committees too often endeavor to mask subsidies by elaborate financial vehicles which have the aura of market instruments.

SALE OF LOAN ASSETS GOOD IDEA

This is the reason why I am particularly impressed with the administration's proposal to immediately sell loan assets upon issuance and without recourse. The market will immediately create a value for the loan asset that will directly measure the amount of subsidy implicit in the original loan. In general, therefore, the major argument for sales of existing loan assets is that most of them should not have been there in the first place.

Loan asset portfolios of the Federal Government are too often handled in a non-business manner. Collections are lax, administration poor, and profits generally non-existent. The reason, of course, is that the employees of agencies running many of these programs understand, as do many of the members of the relevant congressional committees, and the recipients of these loans that they are not, in fact, loans in a fully commercial sense.

They are to a large extent subsidies in the attire of a legitimate loan portfolio. Many, if not most, could be classified as low-grade Federal junk bonds. Sales of loan assets to the private sector, however, would create sharply discounted paper, but paper which when discounted would have real economic value, a market rate of return, and compelling reasons on the part of the private sector to administer the discounted portfolio as a business.

This would, in effect, create marketplace discipline for the allocation of credits and sharply differentiate between subsidies and loans in Federal Government programs. The selling off of loan assets of necessity will reduce the gross interest received by the Federal Government to the extent that the salable assets are, in a banking sense, performing loans.

However, such sales will also reduce the carrying costs to the Federal Government by an equivalent amount since the proceeds of the loan sale will reduce the required level of outstanding Treasury securities. Moreover, administrative expenses would also be removed, at least on the presumption that the employees and overhead associated with such loan asset interest allocations would be eliminated.

The difference between the net proceeds of loan asset sales and their book value represents the amount of subsidy that must be financed by an equivalent amount of Federal debt.

The discounted part of the loan assets never had an income or value whose loss will increase future budget deficits. Even the fact that the Treasury can borrow at a lower rate than private business is offset by what must almost surely be a lower cost of administration of loan portfolios by the private sector.

Hence in any meaningful sense the sale of Government loan assets should not materially increase future deficits. The major credible argument against loan asset sales is that under current accounting procedures they reduce Federal outlays on a one shot basis and hence are apt to divert long term budget deficit reduction from the appropriate focus on core receipts and expenditure adjustments.

Moreover, it is argued correctly that sale of Federal loans has the same impact on interest rates as the sale of other Federal securities, has Marty Feldstein has pointed out. This suggests, as CBO has noted, that the sales of loan assets be counted as a means of financing the deficit rather than as a reduction in outlays.

Mr. Chairman, the remainder of my remarks generally refer to the longer term questions of budget control and I request that that be submitted for the record.

Chairman CHILES [presiding]. Indeed, it certainly will be included in the record.

[The prepared statement of Dr. Greenspan follows:]

Excerpts from the Testimony of Alan Greenspan*

Before
theUnited States Senate
Committee on the Budget

February 19, 1987

Government loans have had a checkered history. Almost always at some subsidized rate, they are part of a segment of federal fiscal activities that employ a variety of different vehicles to mask direct payments from the federal government to specific constituents. We see it in the social security system where the present value of payments into the Old Age and Survivors Insurance funds, by both employees and employers, falls short of the average present value of insured benefits. Nonrecourse crop price support loans simulate a market transaction, when in fact, they are an implicit cash subsidy. Premiums into the FDIC and, certainly, the FSLIC create entitlements that will almost surely prove to be significantly in excess of the present value of insurance for depositors.

The most direct evidence of the existence of hidden or partially hidden subsidies is the fact that the market value of federal governments loan assets is only a moderate fraction of reported book value.

It should be a cardinal principal of budget policy that services rendered to constituents by the federal government be accurately labeled: a subsidy, a loan, an entitlement, etc. Too much effort is expended by legislation to obscure the nature and size of payments to constituents. Budget policies of both presidents and congressional committees too often endeavor to mask subsidies by elaborate financial vehicles, which have the aura of market instruments.

This is the reason why I am particularly impressed with the Administration's proposal to immediately sell loan assets upon issuance and without recourse. The market will immediately create a value for the loan asset that will directly measure the amount of subsidy implicit in the original loan.

*Dr. Alan Greenspan is President of Townsend-Greenspan & Co., Inc.

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In general, therefore, the major argument for sales of existing loan assets is that most of them should not have been there in the first place. Loan asset portfolios of the federal government are too often handled in a nonbusiness manner. Collections are lax, administration poor, and profits generally nonexistent. The reason, of course, is that the employees of agencies running many of these programs understand, as do many of the members of the relevant congressional committees and the recipients of these loans, that they are not in fact loans in a fully commercial sense. They are to a large extent subsidies in the attire of a legitimate loan portfolio. Many, if not most, could be classified as low grade federal junk bonds.

Sales of loan assets to the private sector, however, would create sharply discounted paper, but paper, which when discounted, would have real economic value, a market rate of return, and compelling reasons, on the part of the private sector, to administer the discounted portfolio as a business. This would, in effect, create market place discipline for the allocation of credits and sharply differentiate between subsidies and loans in federal government programs.

The selling off of loan assets, of necessity, will reduce the gross interest received by the federal government to the extent that the saleable assets are, in a banking sense, performing loans. However, such sales will also reduce the carrying cost to the federal government by an equivalent amount, since the proceeds of the loan sale will reduce the required level of outstanding Treasury securities. Moreover, administrative expenses would also be removed, at least on the presumption that the employees and overhead associated with such loan asset interest collections would be eliminated.

The difference between the net proceeds of loan asset sales and their book value represents the amount of subsidy that must be financed by an equivalent amount of federal debt. The discounted part of the loan assets never had an income or a value whose loss will increase future budget deficits. Even the fact that the Treasury can borrow at a lower rate than private business is offset by what must almost surely be a lower cost of administration of loan portfolios by the private sector. Hence, in any meaningful sense, the sale of government loan assets should not materially increase future deficits.

The major credible argument against loan asset sales is that under current accounting procedures they reduce federal outlays on a one-shot basis and, hence, are apt to divert long-term budget deficit reduction from the appropriate focus on core receipts and expenditure adjustments. Moreover, it is argued (correctly) that sale of federal loans has the same impact on interest rates as sales of other federal securities. This suggests, as CBO has noted, that sales of loan assets be counted as a means of financing the deficit rather than as a reduction in outlays.

The basic problem with the federal budget deficit remains the current structural imbalance that will eventually have to be redressed if private capital investment is to add to our competitive capabilities. We delude ourselves into believing that because our long-term budget projections are inevitably benign, time will ultimately resolve the problem one way or the other. It probably will, if for no other reason than financing difficulties will eventually exert pressure for a quasi-permanent solution. The difficulty is that the long-run solution is almost surely going to mean increasing taxes. Such a solution will once again underwrite the seemingly inexorable upward drift of federal spending as a share of the national product. The composition of federal outlays continues to change decade by decade with national defense alternately rising and falling as an overall share. Nonetheless, total outlays seem irresistibly to take an ever increasing share of national economic output. Federal outlays, which totaled only 17% of the GNP during fiscal 1956, rose to 21-1/2% in 1968 at the peak of the Vietnam war but, with real defense outlays sharply lower through 1975, the percentage stabilized. Domestic spending filled the gap of lower defense outlays, however, and continued growth in the latter brought outlays to 22% of GNP by 1976. The inevitable rebound of defense brought total outlays to 24.3% of GNP in fiscal 1983. In fiscal 1986 it had retreated slightly to 23.8%.

The Administration is forecasting a significant decline in the budget deficit and spending's share of the GNP over the next several years, but the gains are likely to be far short of what is now officially contemplated either by OMB or CBO.

The basic budgetary problem is, at root, political. We remain a democratic society in which members of the Congress are competitively pressured in most areas of the country to, in effect, buy votes from their constituents by offering what is perceived of as costless benefits. Subsidies masked as loans is only one such vehicle. The Congress to be sure, in recent years somewhat to my surprise, has endeavored where possible to pull back from that practice and try to hold the line on new programs. That, of course, has been the cause of the recent significant retrenchment in domestic spending as a share of the GNP.

However, proposed catastrophic insurance programs threaten a reemergence of the upward trend. It may well be argued, as indeed it will, that such government backed insurance is essential to a significant and growing proportion of our population, and that its cost is containable and is, hence, no threat to the budget. But virtually all expenditure programs, considered individually, have merit. The problem is that taken in total we cannot afford them. If Medicare is any guide, catastrophic insurance costs will expand far beyond any current contemplation. Program curtailments and cost containment become politically difficult once a program is in place and constituencies formed.

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The only encouraging indication that we may, in fact, be able to balance our fiscal accounts is the way in which the political negotiations on the tax bill requiring revenue neutrality were conducted. I don't believe the tax bill was in fact revenue neutral, but it is sufficiently close to suggest that the Congress does at least have the capability under certain restricted institutional conditions of balancing costs and benefits.

The experience of the last few years raises a question of whether the long-term institutional bias towards increasing federal government outlay shares of the GNP has come to an end. The enthusiasm for catastrophic insurance, however, leaves me skeptical. It is certainly the case that the United States does not yet match most European countries' government spending as a share of GNP. But we appear to be moving in that direction.

Chairman CHILES. Senator Lautenberg.

Senator LAUTENBERG. Thank you, Mr. Chairman. I just wanted to add my words of welcome—I arrived a little bit later than I planned to—to each one of these distinguished panelist and to compliment them for their remarks and their thoughtfulness.

LOAN ASSET SALES REDUCE GOVERNMENT BORROWING

I detect a little bit of a conflict of view between two very distinguished economists, though each one subscribes to what the other one said, as I heard you. The fact is that the sale of these loans assets does reduce the Government need to borrow. I do not want to debate the issue, particularly, Dr. Feldstein, but it does reduce our capital needs, and I agree with you and Dr. Greenspan in terms of accounting for these loans.

But we have accounted for them in a particular way and they are reflected in—if you can call it that—the Government's balance sheet. It is reflected in our cash flow needs, and unless we change the accounting on the top line, to suggest that changing the accounting on the bottom line would not be of help, I do not think really helps illuminate the problem here.

We have these loans. Dr. Greenspan said that we are not reflecting the cost for handling, we are not reflecting the quality of those credit risks, in many cases. These loans, the day we issue them, are almost guaranteed to be worth a lot less than the face value of the loan as we created it.

Some of these loans are at such ridiculously low rates that the marketplace would automatically discount them substantially. As the chairman knows, and I think you, Dr. Feldstein know, I have been a proponent of selling these loans for several reasons: I see it as a reduction in the cash needs of Government. We sell a million dollars worth of loans that we have already made. If we get back half of that from the marketplace that is \$500,000 on the million that we do not need from other services.

I think it is fair to say that this is not a preferred route to go. I would not choose to do only this, but just as I disagree with the Government accounting of capital costs versus operating costs, I would have to say that these loans, to me, reflect an asset whose true value is not portrayed properly.

And I think it would be a service to the whole country if we said, OK, we have this loan portfolio, if I am not mistaken, will be in excess of \$200 billion out there, perhaps worth \$100 billion, maybe something less than that—and I think it would be important to not only tell the public at large but inform some of our colleagues who do not have the time to get into these things about what the real condition is.

I do not mean to give a speech, I mean to defend a position that I took a long time ago, and that is to dispute the contention that in some way it does not affect our credit requirements or that it does not in a very significant way reflect the true position of our deficit problems.

G-R-H BUDGET TARGET FOR FY 1988

Now, Dr. Feldstein, you have been looking at the budget for some time now. The Gramm-Rudman-Hollings law sets a target of \$108 billion for next year.

Given current economic growth, is that a reasonable target in your view?

Dr. FELDSTEIN. If I thought that that \$108 billion was going to be met by actual reductions in spending and increases in tax revenue I would worry. I would worry about a \$60 or \$70 billion reduction from current levels. But I think that the likelihood of that is so small that I do not worry about the Congress coming out with a number called \$108 billion at the end of this process.

I suspect that when they finally audit that number, when reality gets to play itself out, that \$108 billion will look a lot more like \$130 or \$140 billion and I would be quite comfortable with that. So if you have got to aim high in order to hit a reasonable target, then aiming at \$108 billion does not strike me as a bad thing to aim at.

Senator LAUTENBERG. So if I can decode your response, you are saying no, it is not a reasonable target, \$108 billion.

Dr. FELDSTEIN. Well, I am saying it is a reasonable target, but given that you are not going to hit it. [Laughter.]

Senator LAUTENBERG. That is four strikes for the batter. And you just said \$130 to \$140 billion, if I understood you, a reasonable attainment. So you do not think that is a reasonable likelihood?

Dr. FELDSTEIN. I think that if at the end it turned out that for fiscal year 1988 you had a deficit of \$130 to \$140 billion that would be a good attainment.

Senator LAUTENBERG. Would it be a likely attainment, based on the political realities?

Dr. FELDSTEIN. It would be a much more likely attainment if you aimed for \$108 than if you aimed for——

Senator LAUTENBERG. Would it be a more likely attainment than \$160 or \$150 or——

Dr. FELDSTEIN. If what?

Senator LAUTENBERG. I mean, is that what you think is a reasonable expectation? Is that a reasonable expectation?

Dr. FELDSTEIN. You are asking me to forecast what the Congress is going to do.

Senator LAUTENBERG. What are the other guys in this body besides me going to do?

Dr. FELDSTEIN. Right. I think that is doable. I think it is not easy, but I think it is doable.

Senator LAUTENBERG. Dr. Feldstein, you object to the phoney accounting reflected in loan asset sales but here you give a projection that I think really reasonably reflects a similar kind of condition.

Dr. FELDSTEIN. No, I don't think so, but we will have a chance to see.

Senator FOWLER. Will the gentlemen yield?

Senator LAUTENBERG. Sure.

Senator FOWLER. I will translate for you. What he is saying is that Gramm-Rudman is like the cross-eyed archer. It does not hit many targets but it scares the hell out of everybody.

Chairman CHILES. Senator Rudman.

G-R-H LAW A MENTALITY NOT A MECHANISM

Senator RUDMAN. What a lot of people have never understood, of course, is that Gramm-Rudman-Hollings has never been a mechanism, it has always been a mentality and I think that Dr. Greenspan and Dr. Feldstein have understood that for a long time.

If the Congress adjusts the target then we will miss it by a corresponding amount. If we change it to \$180 billion then I guarantee you the deficit next year will be over \$200 billion. If we set it at \$160 billion it will be \$180 billion. If we set it at \$140 billion it will be \$160 billion. If we keep it at \$108 billion, which is really \$118 billion, it will be about \$140 billion, which is about what I expect.

Curiously, that is precisely the conversation I had with the chairman at the beginning of the hearing this morning.

Dr. Feldstein, how is the bill working?

Dr. FELDSTEIN. I think it is working a lot better than an awful lot of the critics claimed. I say this not just because of the man who is asking me the question, but from the beginning I felt that it really would make a difference. Providing a hard number for people to focus on, I think, has helped.

The possibility of sequestration and the little bit of it that we got in the beginning of last year I think have also caught people's attention, and as a result the deficit is going to be lower than it was last year. And as a percentage of GNP it has come down noticeably, significantly, so I think it does help.

Senator RUDMAN. The major problem we had with GRH and its implementation was that CBO's original projections were only optimistic. At that time, CBO projected a fiscal 1986 deficit of around \$195 billion. The House position originally was that we fix the target at an unreasonably low number—around \$162 billion. The target was eventually set in October 1985 at \$172 billion, as it turned out, contrary to CBO's projections the deficit was \$221 billion that year even with an \$11 billion sequestration. Of course the entire budget process was over for that year.

The problem we are having now is a direct result of the target of the first year. Had that target been set at a more realistic level, we probably would have a different target to work with today. The above notwithstanding, I happen to think this is the wrong time to change it for the very reasons you have expressed.

EFFECT ON SAVINGS RATE OF LOAN ASSET SALES AND RAISING TAXES

On the subject for which we are here today, let me just ask this question. Could both Dr. Feldstein and Dr. Greenspan explain to the committee—you may agree or disagree—what is the difference in the impact on the savings rate for a particular year between selling loan assets and raising taxes?

Dr. FELDSTEIN. On the national savings rate?

Senator RUDMAN. That is correct.

Dr. FELDSTEIN. None.

Senator RUDMAN. There is no difference?

Dr. FELDSTEIN. No difference.

Senator RUDMAN. Do you agree, Dr. Greenspan?

Dr. GREENSPAN. There is going to be a difference but it is not clear that it is significant. There is clearly no difference depending

on whether or not you sell loan assets or you raise Federal securities to close the deficit. But the impact of raising taxes on the savings rate is a very complex issue and I would hate to say that the effect is——

Dr. FELDSTEIN. He did say taxes. Yes, he did. Maybe I misunderstood the question. Did you say taxes?

Senator RUDMAN. Whether you raise taxes or sell loan assets in a particular year?

Dr. FELDSTEIN. Oh, no; I did not hear it that way.

Senator RUDMAN. What is your answer?

Dr. FELDSTEIN. To raise taxes, you will have—depending on the kind of taxes you raise—you will have a higher national savings rate, you will cut consumption. You will cut consumer spending and so you will have a higher national savings rate than if you sell assets—either old assets or Government bonds.

I thought you were asking about the comparison of selling new Treasury bonds versus selling old assets, and that is—they are equivalent.

Senator RUDMAN. Well, if you took a hundred billion—let's take an easy number—\$10 billion in an asset sale, or you raised a particular tax by \$10 billion, that tax came to the Treasury, the Government paid bills with it, how does that change the savings rate of the country? I would like you to explain that.

Dr. FELDSTEIN. Let's take a specific example and say you do it with excise taxes of one sort or another, alcohol taxes. Consumers have \$10 billion less in their pockets to spend.

Senator RUDMAN. Or to save.

Dr. FELDSTEIN. But they do not save it. The percentage of disposable income that people save is roughly 5 percent, so that if you impose a tax of \$10 billion a year on people—particularly if it is a permanent tax that you are now starting and putting in place—people are going to have less income, their consumer spending is going to go down, unlike selling an asset where you simply are going to absorb some of the saving they would otherwise do. Alan.

Dr. GREENSPAN. Yes; the reason I say the results on the savings rate is ambiguous is that there is no ambiguity on the issue of reduced consumption but there is ambiguity on what that does in the macro sense to aggregate incomes. As a consequence it is quite conceivable that raising taxes will not increase the national savings rate. It is important to specify the specific form of tax and the specific assumptions.

Senator RUDMAN. Well, the reason I asked you both the question is because I think the answer is a little obscure to some people. It has certainly been obscure to me with much of the debate that has been raging. I do not think there is any question whatsoever. I agree that in terms of long-term deficit reduction, loan asset sales do nothing to address the structural deficit problem.

Dr. FELDSTEIN. I think you can narrow any apparent difference between Alan and myself as a minimum if we say assuming that the Government takes other policies—monetary policies, whatever—to maintain the same level of real GNP, then I think we have no difference that an increase in taxes will increase the national savings rate. Government asset sales will not increase the national savings rate.

And another way of putting it is that an alcohol tax will have the kind of effect that I describe, will shrink consumer spending and have a minute effect on national income in comparison to some kinds of taxes. Further increases in capital gains taxes is much more counterproductive in terms of its impact on the economy.

JUNK BONDS

Senator RUDMAN. If I might, Mr. Chairman, have just one last follow up to that. I think it is clear that the impact of a tax increase—depending on what kind it is—vis-a-vis selling a loan asset does effect different groups of people rather substantially.

I thank you both very much, and I want to tell you, Dr. Greenspan, I am enamored by your description of this portfolio. I think maybe Mr. Shad ought to write it down and they could stamp it on the offering circular to make sure that there is full disclosure.

You described our federal loan portfolio—if I quote you precisely—as low-grade Federal junk bonds. I think that is a memorable quote this morning. I shall use it, because I agree with you.

Chairman CHILES. That will probably help them get a good rate.

Senator LAUTENBERG. Junk bonds, however, usually have a high yield. These have a low yield. [Laughter.]

Dr. GREENSPAN. No, Senator, in the market they will have a high yield.

Mr. SHAD. Well there are some qualifications to that. There are some, probably, triple-A credits in this portfolio to be sold; the water bonds in some of these communities and what-not. People are going to pay the taxes to service those bonds. They need the water.

But it does have a wide range, and I would certainly agree on the bottom end of it you are looking at competition with the junk bond market or the high yield bond market.

Chairman CHILES. I would say though that Dr. Greenspan would certainly be right. The more and more you sell the lower and lower would be the quality. Senator Sanford.

APPLY ASSET SALES REVENUE TO DEBT REDUCTION

Senator SANFORD. Thank you very much Mr. Chairman. I have been trying to decide first whether I wanted to ask this question to a Harvard economist or an NYU economist, but instead I will just ask it. I have been somewhat offended by our effort to balance the budget by, in effect, selling the family jewels to buy the groceries.

It seems to me that when we sell off assets that we should do so because they ought to be sold and the decision ought to be made on that basis; and there would be a certain political discipline if we had a rule that when we sold the assets that we, like a normal investor, had to apply it to the debt instead of the operating budget.

I would like to ask that question from the point of view of an economist because last month the CBO issued a report that said, and I am quoting, "Many analysts believe that the stock of Government debt relative to GNP, rather than the deficit per se, works most directly to affect the level of interest rates and through them the level of private investment. In other words, the stock of debt

relative to the size of the economy may be more important than the size of the deficit per se."

If this is the case and if, using the CBO baseline, the deficit declines as expected while the ratio of debt to GNP continues rising for a time, would it not make more sense to apply the revenues of such sales to retiring federal debt rather than reducing the current budget deficit?

EMPHASIS SHOULD BE ON DEFICIT

Dr. FELDSTEIN. Well, I think both the level of the debt relative to GNP and the current deficit relative to GNP influence the level of interest rates. I think that the current deficit has a larger impact than the level of the debt, and if you look at where our interest rates got to a couple of years ago when our current deficit was a very large fraction of GNP—5, 6 percent of GNP—and projected to remain so, the big change that has occurred in the last couple of years has been the reduction in that current deficit, rather than in the ratio of debt to GNP. That is what has brought down the interest rates.

So I think while both matter, I would not focus just on the debt at all. I would focus more on the deficit. But I think the implication that I draw from this is how you want to account these changes. And what I said before you came in, Senator, is that I think that for new loans the proposed treatment—selling them off immediately, booking only the subsidy that is left—is a good idea.

For old loans I think it is wrong to take credit as if we had really raised some money when we are just selling off existing assets, selling the family jewels, as you said. So I would rather apply that—it would automatically get applied to reducing the debt, as you say—but I would rather not have that count—for meeting the Gramm-Rudman targets—not have that count as part of the deficit reduction.

And I think that is something you could do. You could have a forward looking policy which gave you the discipline you want and the recognition of the subsidy you want, but not trick yourself by this phoney accounting technique of counting the sale of old assets.

Senator SANFORD. I apologize for not being here and for missing your earlier testimony, but I will read it. We have a great way of scheduling committees here. We've got a computer that works out all possible conflicts and schedules it that way and I had three 10 o'clock committee meetings.

DEFICIT BIG PROBLEM VIS-A-VIS DEBT

Dr. GREENSPAN. Senator, I generally agree with that. I think that the level of the debt is much less relevant than the size of the deficit because the size of the deficit reflects the credit requirements of the Federal Government in the flow of funds and it is in the balance of supply and demand where most interest rate pressures are ultimately resolved.

So there is no question that the deficit—or more exactly—total Federal Government borrowing requirements, net of asset sales, is the crucial determinant in this issue. When you sell an asset out of a Government portfolio you do, in fact, automatically reduce the

Federal debt in the sense that you either apply the proceeds directly against the outstanding debt, or you are required to borrow less than you otherwise would be.

Senator SANFORD. The net effect is the same.

Dr. GREENSPAN. The net effect is the same and it is indeed automatic. There is a crucial problem which this whole loan asset issue raises, however, which is how does, or should, the federal government view its balance sheet? Does it, for example, appropriately view the very obviously marketable resources in the strategic petroleum reserve in the same way as some 2-percent or 3-percent loan asset which, if discounted in the market, would be extraordinarily marked down?

In this sense, I think there is a very crucial rethinking that I have always thought necessary in trying to differentiate among the various items on the asset side of the government balance sheet. Because unless and until we do that we are going to be confronted with issues as to just how to handle various different types of sales.

Senator SANFORD. Thank you.

Chairman CHILES. Senator Nickles.

Senator NICKLES. Thank you, Mr. Chairman. I compliment you on this hearing and for the outstanding witnesses that we have, and I, like Senator Sanford, regret that I was not able to attend the beginning because of another meeting, but I do look forward to reading the testimony of our panelists.

Just a couple of comments. I heard, in the short time that I have been here, almost all negative comments. Would all of you recommend against any asset sales in any budget resolution? Am I hearing that?

Dr. GREENSPAN. No, Senator. I am in favor of selling them, but only because—as I argue in my formal testimony—that most of them should not have been there in the first place.

Senator NICKLES. Like Amtrak?

ASSET SALES NOT TRUE DEFICIT REDUCTION

Dr. GREENSPAN. I am talking about loan assets only. You are raising a much broader question which involves a lot of significant issues. But it is the same principle. I would argue that the stock of loan assets—indeed, the stock of all assets, including Amtrak—are certainly a dubious activity of the Federal Government and the sooner we sell off most of it the better off we will be.

I think where you find agreement is that in no instance should any of these sales—Amtrak included, incidentally—should we somehow categorize sales in the same way as budget deficit reduction as either an increase in the receipts from either taxes or user fees, or expenditure cuts, that is, direct programmatic outlay reductions.

And I think that that would be a view, I would suspect, which would be held generally by the economics profession, and hopefully by John Shad's old profession.

Dr. FELDSTEIN. I agree with that and I think there is a simple way of making that happen in the way you treat this from an accounting point of view. That is, sell off the old assets but do not count it as deficit reduction. Treat them as off-budget items. Sell

them off because it is a good thing to sell them off. Sell them off because you think the private sector can manage the collection better and you want to get the Government out of that activity. But do not trick yourselves by taking credit for it in meeting the Gramm-Rudman-Hollings target.

With respect to new lending, the proposal that you automatically sell off means that all that you will show in the budget is the subsidy—the implicit subsidy—and that is exactly what you should show. So, I would draw a line between the past and the future and say let's go ahead in the future, automatically sell the loans and write down the net transaction in the current budget. But for the past, if you sell them off, do not trick yourself by taking credit for it.

Senator NICKLES. Sell them off in the same year that they would be issued?

Dr. FELDSTEIN. For new loans, yes. For new loans, sell them off as they are issued, as proposed by the administration. And what that means is, in effect, if you provided a loan which was really on market terms so that you lent out \$100 million, and you could turn around and sell that paper for \$100 million, the budget impact would be zero. If you lent out \$100 million and the market only values that paper at \$90 million, then you will show \$10 million in your budget, and that is correct. That is the real subsidy.

I would do that with respect to new loans, but I would not trick myself by selling off tens of millions of dollars worth of stuff that is already on the books and taking credit for it.

SELLING STUDENT LOANS

Senator NICKLES. Take, for example, student loans, which have a very high non-repayment rate or delinquency rate. Let's say we are talking about \$1 billion worth of student loans.

If you were trying to market those, they would be discounted. My guess is they would be probably in the 60 percent range just to guess. So you would have an out-of-pocket loss, would you not, of say, \$400 million in that 1 year.

Dr. FELDSTEIN. Well, now when you lend \$1 billion you have to record the full billion in your budget. What you would be doing under the administration's proposal, which I am supporting in this aspect, is not reporting the full billion of new lending, but only the difference between the billion that you lend and the \$600 million that you get back from selling off that asset. You would only report the \$400 million.

Senator NICKLES. So, compared to current practices it would have a positive impact as far as what it would show for the year?

Dr. FELDSTEIN. That is right. But again, I am saying do not confuse the issue by going back and taking old student loans and selling them off.

Senator NICKLES. I hear what you are saying.

Dr. GREENSPAN. Senator, can I just make one comment relevant to that issue? You are not losing the \$400 million. That \$400 million was lost a long time ago and the face value of most of those loans have always been wrong. It is important to recognize when the actual loss took place.

And that is the great advantage of the administration's new proposal. They will record immediately the true level of the subsidy, and any subsequent loss or gain then is reflected in the private sector. One advantage of the administration's proposal is that it creates the expenditure subsidy at the time it is actually taking place, whereas now we do not have a clue when that \$400 million was lost. It may have been 5 years ago, it may have been 2. We do not know to which budget it applies.

Senator NICKLES. That is a good comment. Thank you. Thank you, Mr. Chairman.

EXEMPT LOAN SALES FROM SEC REGISTRATION

Chairman CHILES. We do have a future hearing set up in which we are going to look at selling new loans and how we should score the substantive value of those loans, so I think that is a valuable thing we are talking about here.

Mr. Shad, parties on all sides are now gearing up for the loan asset sales authorized in last year's reconciliation bill. My understanding is some on Wall Street have volunteered that Congress should exempt Government loan sales from SEC registration requirements, and I want to get your advice on this issue.

The main argument for exemption seems to be it would make the whole process go faster. With the end of the 1987 fiscal year only 8 months away, does SEC have time to complete the registrations? On the other hand, I can think of at least five good reasons why we would be wise to require registration. One of the benefits of privatization is to make more information available about Government loans, and registration would seem to help get that information out.

We are interested in getting the best price. It would seem that we reduce the uncertainty—you have already mentioned that in your statement, I think—of the people buying through the registration process.

Since we would like to see a secondary market develop, they would be more attractive investments, more information available. You touched on that I think. Registration disclosure seems critical where there is not strong collateral backing up the loans. And finally, I wonder what kind of position the Government would be putting itself in if we did not require registration and several of the loans went belly-up. Would not the investors that got hurt have a right to come back and ask us why we did not demand registration.

CAN REGISTRATION BE HANDLED IN TIME FOR SALE

Could you first address the timeliness issue? Can we complete registration by the end of the fiscal year? In your opinion, have the agencies and the financial advisers been moving as quickly as possible, and do we perhaps need to think about some expedited procedure for registration of loans?

Mr. SHAD. Well, I would like to endorse your five points up front. I certainly agree with your characterization of those concerns. I would also like to put them in perspective. With regard to this \$5 billion initial program—these markets that we have today are ab-

solutely incredible. There has been over \$80 billion of somewhat similar obligations registered with the SEC under the shelf rule during the past year.

So you can see that \$5 billion that we are talking about here—Chairman CHILES. It does not overwhelm you then.

Mr. SHAD. No, it does not. The Street could handle it. It is a little more than an odd lot, but it is not an extraordinary amount of paper in this market. I have here an ad out of yesterday's paper for a \$750 million offering by Kidder-Peabody. These are collateralized mortgage obligations; they are somewhat similar, but better credit risks than the paper we are talking about because most of them are Government guaranteed and sold with recourse. So the rates would be different.

REGISTERING BONDS INCREASES VALUE

In terms of what you are going to realize on these offerings, the better the disclosure the less the uncertainty and the higher the price. If you do not lay it out—on either side, whether publicly registered and offered or sold under private placement—there is no substitute for really a full and accurate disclosure of what you are selling because you will get a better price in the final analysis because it will be analyzed. People are not going to bid up for a pig in a poke. They want to know what they are buying.

As to the timing, there are many alternatives available to these agencies to liquidate their portfolios—depending on the quality and the size and the nature of them, but if they do it through a registered distribution, as a rule of thumb, it would take around 30 days. So within 30 days the SEC would do its necessary reviews and comments and the registration statement could become effective.

BIG MONEY INVOLVED—GOOD GROUND WORK SHOULD BE LAID

You are doing something unique here. It has not been done before. And I think it is terribly important from the point of view of the Federal Government that this be a very successful initial pilot series of financings—not one but a whole series of different types of financing to accommodate these needs—because there are a lot more to follow. We've heard the mention of a \$250 billion portfolio that may be worth 50 cents on the dollar, or \$125 billion, but you are just dipping your toe in the water with these initial ones, and I think it is terribly important that they be successful and set the stage for those that will come later.

So I would suggest in terms of timing that these agencies think in terms of pre-filing conferences with the SEC. When they have their deals structured and they know the size and nature of them, the financial advisers and securities lawyers sit down with the SEC staff and go through their plans. If there are problems, it is usually going to be in the documentation area and the collection rates and experiences. Once the agency really knows what you have to sell and how good the quality of it is, time schedules can be established.

If they come in at least by June 30, they have time to accomplish that. If they decide to go through the investment company route and request various exemptions, which was done in a recent offer-

ing by the Small Business Administration of pooled SBA loans, they should allow slightly more time, given certain exemptions from the Investment Company Act because when the SEC grants such exceptions there is a statutory requirement of a 21-day period for an opportunity for the public to request a hearing.

Now, the Congress can structure this as it sees best. But you are going into the market in competition with all other types financing, and I would suggest the right way to do this is not to skew the whole system but rather to play the game in competition with the market for all comparable and competitive paper.

HOW CAN SALES BE MONITORED

Chairman CHILES. Well, I think you have answered the second part of my questions. That is whether you felt we should waive the registration. Let me see if you can give us some advice. We have the responsibility for oversight to try to determine whether the Government is getting the best price it can and to make sure that everything is done on the up and up.

How can we best assure that these sales are going to be done competitively and that we get the most revenue for the Government. Is there a danger of collusive practice between the underwriters or between the financial advisers and underwriters? How do we monitor the prices of the loans over time, try to compare the original price that the Government gets with the subsequent trading prices? What data do we need to gather and how would you suggest that we go about trying to get this data?

Mr. SHAD. Well, to go to the final area there, the best indication of how successful the financing is and whether the Government is fairly treated or not will be the aftermarket. If you do a registered offering you will know very quickly whether it was successful or unsuccessful.

If the underwriters end up with a large unsold position because the Government has driven a very hard bargain and the offering breaks in price, goes to a significant discount, that is going to chill the reception for comparable offerings to come. In some cases it has almost killed the market in certain types of paper.

On the other hand, if it goes for a big premium, comes out and jumps in price, it may not have been as fine-tuned in terms of getting the Government the fair value of the paper as it should have been.

So, the first question is whether it is a registered public distribution or a private placement. On a private placement, you do not have comparable information. They are sold in large chunks—\$100 million would be common—to one or two institutions, and that is a lock-up, it is private and you will not be able to see the market—but the thing you can do, and what investment bankers and the advisers to these agencies will do is to run comparative pricing analyses of all the most comparable publicly traded securities.

And they will also do a financing alternative spreadsheet where they can look at 20 different alternatives for implementing this program according to the quality and the nature of the paper market conditions. So that there are a variety of tools that investment bankers use to be responsive, and in terms of monitoring, the

SEC is a law enforcement agency and we are not the right one for monitoring. Our job is to make sure that we protect investors and have fair and orderly markets.

But I would think that the Treasury is the beneficiary of these financings, they are going to get the proceeds. Certainly they have a self-interest in seeing that they are properly handled, both in getting full value up front and in terms of the program that is being carried forward.

So I would think that the Treasury or OMB would be logical places to expect to carefully monitor how well the program is being implemented. If you sense collusion, I think it is a valid question, but on the other hand, I know that our security markets today are the envy of the world. They work like a precision mechanism.

It is absolutely incredible. Here we are talking about \$5 billion of financing. Well over \$50 billion of securities change hands daily in America over the telephone with documentation that comes 3 days later. We have got extraordinary markets. They are the world's best. They are the envy of the world, and I think you can assume and I know you can work with the quality of advisers that have already been selected by two of the agencies.

They are absolutely prime name banks in this case; Manufacturer's Hanover and Chemical. And they are experienced in getting good people within those organizations to do the work. I would take great comfort in the government being well served.

Chairman CHILES. Well, I appreciate that answer. I think we all took great comfort in how all of those transactions were taking place. We have all been a little shattered lately to find out that with all these transactions taking place, in some of the best names that we have known, it appears that there has been some collusion.

So we have some kind of warning out there in front of us. Dr. Greenspan, you are certainly recognized as one of our nation's top financial advisers, not only in theory, but also one that knows what makes the Street tick.

METHOD OF SALES TO USE AND OVERSIGHT

We would like your advice on how we could best structure these loans and what you would recommend. Should it be competitive bidding, or negotiated sales, and how should the underwriters' fees be structured so that they are given an incentive to do the best job for the Government. We want your advice on how we would monitor for any collusive practices in trying to find out if we got the best deal we could have gotten?

Dr. GREENSPAN. I basically subscribe to what Chairman Shad has been outlining. The sale process is something we have done over the years quite successfully in comparable vehicles. As John Shad pointed out in this Kidder-Peabody ad, securitized mortgage loans, is a relatively new vehicle, meaning relatively new in recent years. But it has come to the point where there is a high degree of sophistication, and competition. I would, think in terms of endeavoring to insert the Government in that market as though it were another private institution.

Obviously, if the loan sales become extraordinarily large relative to the size of the market, then clearly different arrangements

would have to be made. But considering the nature and the size of the types of instruments which are contemplated being sold, the simplest and perhaps the most effective way that the Government can behave in this regard is to behave as though it were merely another private seller of instruments. I suspect under those conditions the Government would get its best price, and probably—provided it handled all other aspects appropriately—have the least negative impact on the market. So long as we do not endeavor to sell huge blocks immediately of the types of instruments, which are unknown to the financial institutions, I see no difficulty whatsoever in the types of sales which are currently contemplated.

CORPORATIONS SWAP LARGE DEBT FOR EQUITY

Chairman CHILES. Mr. Shad, this question will move us a little away from the loan sale issue, but it is related to the disclosure in a general sense. In the last several years our corporations have been swapping debt for equity in record amounts, perhaps as much as \$200 billion in the last 2 years alone.

We recognize a lot of that is corporations being reorganized to better compete in a changing economic environment. Certainly part of it has been associated with a desire for quick profits on speculation with little care for the long run. One of the things we have been increasingly worried about is that our corporations seem to concentrate too much on their quarter to quarter situation. They do not think enough of the long run.

What kind of things can be done to help our businesses take a long-run perspective? I know that deficit reduction to reduce real interest rates and to free up savings has to be at the top of the list, but beyond that what kind of things can be done to induce our businesses to make longer-term commitments, pay off in terms of market presence.

Would it not help if investors and policy makers were able to monitor the kinds of longer-term commitments that our businesses are making. If businesses were required to disclose their expenditures on R&D, how much they put into capital formation, how much they are spending on training, how much on attempting to penetrate foreign markets and learn what the foreign competition is up to. I would just like your opinion on whether it would be a good idea to develop some measures of long-term commitment and require that these be available to the public, or would that just be a greater hassle?

Mr. SHAD. I think much of what you touched on is available in various forms. If material, the R&D is a disclosure item. And when you go through an operating statement of a company there is great detail in the notes to the financials as well as the financial statements themselves. A very important section of the registration statements of companies and their 10-K's—their annual reports to the shareholders, the public, and market regulators and others—is the management's discussion and analysis of its current financial condition and ongoing operations, where they really are quite candidly discussing the kind of areas that you have raised—their concerns or what they are doing about their concerns, what their liquidity is, and future prospects.

The markets, of course, put heaviest weight on proven performance. So if the company has an outstanding track record of doing successful R&D it will command a higher price in the marketplace. Some articles say the companies with large R&D programs have been the targets for takeovers. That is not true. It is just the opposite. We have run studies and found that by and large those companies sell at higher prices than the ones that do not have advanced forward-looking growth programs.

INVERTED PYRAMIDS WILL TOPPLE

And also, another area you mentioned—this \$200 billion of debt—I have said in times past that the more leverage buy-outs and takeovers today, the more bankruptcies tomorrow. The next recession or rise in interest rates is going to tip over some of these inverted pyramids that have gone from 80-percent equity to 80-percent debt, 20-percent equity.

But so far the rewards—the benefits to the economy and to the investors—have significantly outweighed the losses in bankruptcy. The premiums that shareholders receive—well in excess of \$50 billion in the recent past—are immediately reinvested in the market. They go into, in many cases, high-tech and growth companies. It helps the system. It is coming out of a recapitalization. It is a leveraging up.

And I would also add on this question about a concentration on quarter to quarter results—we get this a lot from management, that they are being threatened and forced to go to short-term planning. The markets are not that superficial. They do see it where there is merely a goose in the latest quarter's earnings. They do put a premium on outstanding long-term performance.

And frankly, managements are in the best position to take advantage of undervalued assets and untapped borrowing capacity rather than let some outsider come in and, in effect, buy the company against its own credit, finance it out and do that. And the fact of the matter is, management's are doing it. By and large corporate managements are improving the return on their investment and the growth prospects and the employment of their assets. That has been going on for a long time.

It could always be better, but I do not think we should assume that they are ignoring these things. I know that the marketplace is not. The marketplace is far from perfect, but it does a very good job. It makes a very efficient allocation of capital in determining the value of the paper of these companies

WILL HEAVY BORROWING EXACERBATE TRADE DEFICIT

Chairman CHILES. Dr. Feldstein, you spelled out in the clearest of terms that loan asset sales are not deficit reduction. I would like to get your opinion on a related and critical matter. Would you agree that unless we do some real deficit reduction our national borrowing needs will not fall and we will have to keep on borrowing from foreigners? And is not the inevitable counterpart of all that borrowing continued high trade deficits?

If we turn to loan asset sales to fool ourselves thinking we are reducing the deficit, are we not, in fact, guaranteeing that, the

trade problem is not going to go away. For all the talk of trade law reform and competitiveness initiatives—not to say that they are not important in their own right, I certainly think they are—but is it not true that by whatever good measures they might bring, they will be swamped by refusing to really deal with the deficit?

Dr. FELDSTEIN. Well, I think that our very strong dollar has been and continues to be the primary source of our trade problem and that the ultimate reason why the dollar went up so much was the powerful borrowing needs of the Federal Government. So that bringing down our Government's borrowing needs—real borrowing needs—credit needs, regardless of whether met by asset sales or by Treasury bonds, is the best way to bring down interest rates, the dollar, and our trade deficit.

We may not have any choice about borrowing from abroad. Foreigners may get tired of adding hundreds of billions of dollars to their portfolios of foreign securities. This year they will buy \$140 billion worth. It is estimated that by the beginning of the next decade they will have nearly a trillion dollars worth net of investments in the United States. They may not want to do that.

And if they do not, they we will not be able to rely on a continued capital inflow from abroad. And while that may be good news for our trade balance, what it will do is push interest rates up much higher here. So that as long as we go on borrowing—we, the Federal Government—goes on borrowing at the rates that it has, there is going to be either the trade problem that you pointed to, or high interest rates and poor housing or investment performance here in the United States. The key thing is to try to avoid both of those problems by bringing down the Government's borrowing.

BORROWING LESSER OF CHOICES

Chairman CHILES. Dr. Greenspan, as I understand your testimony you seem to say that while you do not think selling assets was the greatest way to deal with the deficit, compared to raising taxes it may be as good. You fear that raising those taxes will increase the desire for further spending, and that means you will not get something off of the deficit. Am I characterizing your view correctly?

Dr. GREENSPAN. You correctly identified a problem that I have in my testimony but which I did not spell out here. Mr. Chairman, I am terribly concerned about the seemingly inexorable rise of Federal outlays as a percent of the GNP.

What concerns me is that confronted with the deficit problem, that the simplest solution which is more likely to happen than not, is that we will solve the deficit gap from the tax side.

I have a certain ambivalence about that because while continuing the budget deficit is very dangerous, I am concerned that solving it wholly from the tax side reaffirms the long-term growth in the share of the GNP which is going to Federal outlays.

And while it is certainly the case that the United States, say relative to Europe, is still low in the context of where some of their numbers are, we are on a longer term track which will get us there. While we may have great problems with the Federal deficit as we do, I would hate for us to trade that in for another problem,

which would be a balanced budget but balanced at an extremely high levels of outlays to GNP.

I am basically concerned that this issue be resolved wholly from the tax side.

ASSURE SPENDING CUTS FOR REVENUE ADJUSTMENTS

Chairman CHILES. Well, I understand that, and I think there is a very valid reason. Taxes, as a percent of GNP, have fallen from about 20.1 percent in 1980 to 18.5 percent in 1986, and during that same time spending has gone up from 22.7 percent to 23.8 percent.

While taxes were going down spending was going up. So spending can go up and you borrow the money to spend as opposed to raising the taxes to spend.

I am a creature of my earlier upbringing. I spent 12 years in the State legislature of Florida. Before we could go home after a legislative session, whatever we decided to appropriate we had to raise the taxes to pay for it.

It was about the best restraint I know of for new appropriations because we raised the tag tax one time. We about doubled it. It was \$7 to \$15 for an auto tag. And we put on a fresh water fishing license and half the State legislature got defeated. There was a direct correlation between what we decided we were going to spend that money for and what we were doing.

Here, you just start a new program and you borrow the money for it, so there is no accountability. But when you have to go back and account for why you did something in taxes, to me, that is a pretty good accountability.

If we could design a deficit reduction package and try to say through the Reconciliation Act, Mr. President we are putting on your desk a deficit reduction package with a 3- or 4-year spending cuts. They become law when you sign them. We are asking for some revenue and it will be a portion of what we asked for in the spending cuts—again, over a 3- or 4-year package—so that we can assure you that those spending cuts will go into effect and be there and the revenue will come off of the deficit reduction.

Do you think that that would be a sound way of trying to approach this?

Dr. GREENSPAN. Yes, I do, Mr. Chairman, with one caveat. I would argue that for economic and budget policy reasons, that whatever revenues you raise not be from the income tax but rather from some consumption tax.

Chairman CHILES. Mr. Greenspan, I can assure you this Congress is not going to raise the income tax now. And I can assure you that the Democrats are not going to do that, and I think I could even assure you both sides. We have made sacred right for now the 28 percent, and so I do not think we are going to touch that right now. Senator Lautenberg.

SUPPORT FOR LOAN ASSET SALES

Senator LAUTENBERG. Thanks, Mr. Chairman. I will try to be brief. I just wanted to point out for the record that we have letters here signed by James Toffee, managing director of First Boston, in response to the initial proposal to sell loan assets, in which he says

that to sell a portion of the Federal Government's loan portfolio would reduce outstanding Federal debt and lessen pressure on interest rates from federally sponsored borrowings. One here from Mr. Jim Robinson, who is the CEO at American Express, said you could also cut Federal borrowing costs by reducing Federal debt.

OLD LOAN ASSET SALES

I think it is fair to say that loan asset sales are by no means the answer to the maiden's prayer. It also is something, I think, that by virtue of the action highlights the cost of subsidy, the inefficient collection process, et cetera. And with all of those factors considered, Dr. Feldstein, do you hold to the position this is not even worth a quote "demonstration project," a pilot program?

Dr. FELDSTEIN. No; let me be very clear. I think it is worth selling the new assets as they are originated and treating them for accounting purposes as proposed. But respect to old assets, while I think selling them may be a way of getting them handled more efficiently, it is a mistake to take credit for them in the deficit reduction process, and so I would go ahead and sell them for the credit market reasons but treat that as an off-budget transaction.

Senator LAUTENBERG. But in addition to recognizing the inappropriate value placed on these old obligations, or old loans, there is something, I assume, to be said for—and you agree—straightening out the accounting process.

Dr. FELDSTEIN. But this will make the accounting process worse rather than better because you will take into current income—if you put it in a business sense it will take into current income the proceeds of an asset sale.

Senator LAUTENBERG. Well, that is the problem with the whole accounting process anyway.

Dr. FELDSTEIN. But it makes it worse. And I am saying keep it out of the current income flow, but it, obviously, will reduce the size of the outstanding debt.

Senator LAUTENBERG. OK. Does that have value in itself?

Dr. FELDSTEIN. No.

Senator LAUTENBERG. Not to reduce the size of the outstanding debt?

Dr. FELDSTEIN. No.

Senator LAUTENBERG. Even off balance sheet?

Dr. FELDSTEIN. No.

Senator LAUTENBERG. So you are saying no, that is does not pay to do this?

Dr. FELDSTEIN. It may be a better way to get the debts collected, to put them into private hands.

Senator LAUTENBERG. Yes; but in terms of either the deficit or the total debt, it has no value?

Dr. FELDSTEIN. Because I assume that anybody who really cares about how big the debt is of the Federal Government says, well, the Federal debt is whatever it is minus the roughly \$150 billion which is the present value of the loan receipts that are represented by that portfolio. Whether you actually recognize it by selling them or not is irrelevant.

Senator LAUTENBERG. You gave credit earlier to the objectives, the targets, set by Gramm-Rudman-Hollings. You said that even if we miss, I think you confirmed what Senator Rudman said, that it is worth having these objectives out there, these goals out there.

Does not the same thing apply in the case of these loan assets? It is an objective. It redivests our thinking. Some argue that it probably would not be necessary to reduce the deficit to zero in 1991, but rather that the target could be extended. Would you agree that if we extended the date for achieving that object by ten years or five years or something it would not matter?

Dr. FELDMSTEIN. No. The idea of extending it for 10 years bothers me a lot.

Senator LAUTENBERG. Five years?

Dr. FELDMSTEIN. Even 5 years I would oppose. I think that having the target there is a very important goal. It may be that it will have to be pushed forward as we move closer to the date, but to say that it so far—that reaching the budget balance is so far in the future that we should not think about it—

Senator LAUTENBERG. OK. All I am trying to do is get an understanding of whether or not since that is a goal and objective, whether the sale of this loan asset may not be of the same direct value that I see it to be. And I do see it to be—and I think it is confirmed by people in the financial community. It starts to create an environment or an atmosphere that says, hey, listen, this is something that has been wrong for a long time, we ought to get on with it. You agree on the new sales?

NO PROBLEM WITH NEW LOAN SALES

Dr. FELDMSTEIN. On the new sales. That is a very, very big difference. You cannot undo the mess. You cannot undo the subsidies that you have already built in to the old loans. But what you can do is fool yourself into thinking you have a smaller true budget deficit if you sell those old loans off and take credit for the cash that you received.

I have a feeling that it is not really an issue about whether those sales are going to occur. I think they are going to occur. It is certainly the tone of this hearing. The question is how they are going to be recorded and whether they are going to be counted as deficit reduction or not. And I think that is the mistake. We are counting them as deficit reduction.

Senator LAUTENBERG. Alan, do you have a comment?

PROBLEM LIES WITH OLD LOAN ASSETS

Dr. GREENSPAN. Yes; one of the problems with selling old assets, is that we do not know the appropriate year to apply those cash receipts to. The reason the issue of how to handle the specific new loans has arisen is that you immediately segregate a true loan into its true market value in which there is zero budget effect and the subsidy in the time in which it takes place.

The trouble that we have with that old loan portfolio, say assuming it is worth 50 cents on the dollar, when you sell off part of it, is that we do not know that appropriate time to which we should apply the receipt. Had we in the past been selling loans quickly re-

flecting the new administration proposal our deficit history would have been different.

We are currently doing the same thing a company does which had a loss 5 years ago but never recognized it and it is doing so now. It is the same process. We have to be careful about deluding ourselves as to what the real budget deficit is.

Dr. FELDSTEIN. The irony is that when a company decides to recognize a loss because it has an asset of lower value, in its current year it will show that as a loss. The way the Government would do it, it will show the sale of it as a gain.

Senator LAUTENBERG. Well, how do we write down the difference between the face value that it is being carried at and the realized value?

Dr. FELDSTEIN. By not taking it into the current year's flow. You will just reduce the outstanding debt by the receipts you get but you will not reflect it in the current year's deficit.

Senator LAUTENBERG. Thanks. Mr. Chairman, I just want to say that I am pleased to be with all of these witnesses, each of whom I know one way or the other, and to compliment Chairman Shad for the diligence that he has pursued securities violations. All of us respect that job. John, I am pleased to acknowledge it publicly.

In terms of your question, Mr. Chairman, about what you do about getting companies to adhere to long-term planning versus the short-term result, all they have to do is match government. I mean, that is the way we do things around here, right?

Thank you very much.

Chairman CHILES. Senator Grassley.

Senator GRASSLEY. Mr. Chairman, I am not going to exercise my option this time to ask questions. Thank you very much.

Chairman CHILES. Senator Conrad.

ECONOMIC EFFECTS OF RAPID DEFICIT REDUCTION

Senator CONRAD. I was pleased to hear a member of the panel—Dr. Feldstein, I think—talk about the problem of overvalued dollar, high real interest rates, the effect on our trade deficit. I come from a State that is productive—in the productive sector we are an agriculture and energy state. I have just come from 6 days in the State.

We are in the deepest trouble, perhaps, that I have seen in my lifetime, certainly, and as I analyze what is happening to us, the pressure of the Federal deficits, pressure on real interest rates, pressure on the value of the dollar, is having an extraordinarily adverse effect on the economy of my State.

If that is the case and if there is anybody here who disagrees with that, I would certainly be pleased to hear it. But if that's the case, why should we not be pushing for a more rapid reduction to the deficit? What adverse effects would come from a more rapid reduction of the deficit than called for in the Gramm-Rudman targets?

Dr. FELDSTEIN. Well, I am hardly the person to tell you not to push for a rapid reduction of the budget deficit. The general problem of going too fast, of course, is that you can push the economy into a recession, and that would clearly be counter-productive.

Senator CONRAD. What set of policy choices, in your judgment, would push us into a recession if we moved more rapidly toward a balance budget?

Dr. FELDSTEIN. I think the critical thing, in terms of the problems that you raised—in terms of the interest rates, and the dollar, and the impact that that is having on the American economy—is getting the future budget deficit down. Not the 1987 or 1988 budget deficit, but the whole path stretching into the future.

You could persuade the financial markets that this government was serious about bringing down those future deficits if you enacted changes this year that moved us along the Gramm-Rudman path with a fair degree of reliability. Then we would see a substantial reduction in interest rates and in the dollar relative to what we would otherwise have.

And you do that without the damaging impact to short-term demand that would occur if you had a very big drop immediately in the size of the deficit. So the ideal arrangement is one in which your short-term reduction of the deficit is not so large but your long-term one is persuasively large.

Now, the only way you can really convince the markets that you are going to get a \$100 billion below where you are now 3 years from now is to make a big step in that direction. But I think you have got to balance those two.

The critical thing is the expectation about the future, and the more of that that you can get without doing the damage that comes from an excessively large reduction of the deficit in the short run, the better.

ATTACK THE LARGE TAX GAP

Senator CONRAD. Let me ask this. I come from a position of a State tax commissioner. That was my job in my previous life, and we had in my State what I called a Fair-Share Tax Program, one that aggressively attacked what I see as the tax gap—the difference between what is legitimately owed and due and what is being paid.

As you are perhaps aware, that gap has grown dramatically in the last 9 or 10 years in this country. Is there any reason—economic reason—why an aggressive attack on the tax gap would be counter-productive?

Dr. FELDSTEIN. Well, I am not quite sure what you have in mind. Do you have in mind things like the underground economy and people just plain cheating in their reporting of incomes?

Senator CONRAD. Two elements really. One is precisely as you describe. The other is what is being reported and not collected. Accounts receivable went up 31 percent last year. So that is not cheating: that is income people reporting and not paying, companies reporting and not paying.

And then as you describe, you have the whole other part of it which is the underground economy.

Dr. FELDSTEIN. Well, in principle you would like to get both of those down. You do not want—well, yes. I will agree. In principle you would like to get both of those down. I do not want to elaborate on that.

Dr. GREENSPAN. Senator, are you referring to the corporate issue of sharply increasing deferred income tax on the shareholder reports, or are you referring to the accounts receivable on the part of the U.S. Treasury with respect to basic receipts?

Senator CONRAD. Right.

Dr. GREENSPAN. That is really a question of required acceleration of liabilities—accelerated payment of existing liabilities—which we have been doing for a number of years.

Senator CONRAD. No, no. I am referring to the latter, which is money that is reported—that is owed—and not paid. The amount is staggering. I mean, as I study this—just as I studied my State situation when I was tax commissioner and proposed a Fair-Share Program—I have become increasingly convinced that the same situation applies at the Federal level.

That is, if you look at the audit rates—effective audit rates—they have declined dramatically in the last 6 years. If you look at what has happened to the accounts receivable—Federal Government accounts receivable have grown dramatically.

REVENUE SERVICE IN DISARRAY

If you deal with the revenue service on a consistent basis, as I did as a State tax commissioner and as chairman of an association of tax commissioners, you find that the revenue service is in rather serious disarray. And I do not think it is a matter of leadership, frankly. I think it is a matter of resources, although leadership and some decisions that have been made there could be questioned, too.

But the point I make is that if you look at what we are faced with here in the budget Committee, realistically—you start with the CBO, \$135 to \$140 billion of deficits. You add the \$18 billion of cuts which Congress has previously rejected. You are about \$158 to \$160 billion and we have got to get to \$108 billion or at least make a dramatic move in that direction.

How are you going to do that, realistically? How are you going to do that, given the pressures around here?

Senator SASSER [presiding]. Gentlemen, would you try to make your answer as brief as possible, we are running out of time.

Dr. GREENSPAN. I would just say, Senator, with great difficulty.

Senator CONRAD. Well, that is helpful. I find that you have got to do something on the revenue side, clearly. I think a Fair-Share Program is a first step. And you have got to do something on the spending side that is dramatic.

Senator SASSER. Thank you, Senator Conrad. Senator Wirth.

SEC BUDGET COVERED BY USER FEES

Senator WIRTH. Thank you very much, Mr. Chairman. Gentlemen, thank you very much. It is good to see you all again.

Mr. Shad, I particularly wanted to come over and say hello to you and your distinguished associates who are here after all of our years of working together and to commend you on the budget which you sent up to the Congress.

Over the years we have had a lot of discussions, as you know, about whether one could do more with more or more with less, or whatever. And I am delighted to see that you have come up here

and defined very clearly what it is that you need in terms of your enforcement activities, which I think everybody up here certainly wants to support in every way that we possibly can.

That is also by way of commending you and Mr. Lynch and so on for the very diligent activities at the SEC. And rest assured that there is strong support for those activities up here.

I also want to make sure for the record that we all understand that that increase in budget requested by you is all paid for by, effectively, user fees. Is that not the case, that the SEC is self-funding?

Mr. SHAD. The budget increase would be out of appropriated funds. There would be other financing involved in the case of the electronic disclosure system out of user fees.

Senator WIRTH. But does not the SEC more than pay for itself in terms of the funds that come into the SEC?

Mr. SHAD. Oh, in that sense we have, you know, about 100 percent surplus. For the fiscal year just ended the fees exceed the budget by about \$119 million.

Senator WIRTH. And those fees go into the general Treasury; is that correct?

Mr. SHAD. They go to the Treasury.

Senator WIRTH. So therefore the request from the SEC is, in fact, more than paid for by fees that come back into the Treasury, and anybody saying that this is an excessive use of general revenues would be incorrect; is that not right?

Mr. SHAD. What you said is exactly right. This will not even begin to use up the surplus that the SEC fees generate over its actual budget.

Senator WIRTH. I just wanted to make sure everybody understood that.

Mr. SHAD. The other issue was the financing of the electronic disclosure system which is included in this. Part of the increase is to cover the up-front cost and the other part—well, the proposal is to finance the dissemination of that information through user fees.

CORPORATE MERGERS AND ACQUISITIONS

Senator WIRTH. Let me move very rapidly, if I might, to a question about the mergers area. I think we have exhausted a lot of the other issues this morning and I wanted to get the comments of Mr. Feldstein, Mr. Greenspan, and Mr. Fleischman, on an upcoming report.

The subcommittee on the House side which I used to chair is about to come out with a report that will be out next week or the week after. What that is going to say is: after about 2 years of exhaustive work where we worked with all of you in looking at the whole issue of mergers and acquisitions and their impacts on the economy—and this will be a report coming out under my name—that with the exception of some, efforts on the margin, such as closing the 13-D window, and two-tier tender offers, the evidence did not appear to be there that we should have major legislative shifts.

If you have all kinds of authority under the Insider Trading Act of 1983, and if there is a need for a definition of that, as the court may suggest, then perhaps we ought to go back and do that. But

outside of those changes on the margin, what we ought to do is let the marketplace work this out. There should not be, despite the fashion of the time, sort of a rush to legislate.

What I wanted to do—I suspect that that fits your perception of this, Mr. Shad—what I wanted to do is to get Dr. Feldstein's, Mr. Greenspan's and Mr. Fleischman's reaction to that. Granted this is an enormously complicated subject and we have about 3 minutes, but you know how we live in these compressed time-frames, Marty.

Dr. FELDSTEIN. I think I agree with the report that I have not seen.

Senator WIRTH. I will send you one. We will have the summary out within the next 10 days and I would be delighted to get your reaction to it.

Dr. FELDSTEIN. Good. But I do think that there are things, like the two-tier offer, which do create problems. A lot of companies have been able within the existing law to take steps now to protect themselves from overly aggressive raids to slow that process down. The question is whether the law will continue to uphold that or whether that will be overthrown by the courts.

But as things are being handled now legally, I agree with what I take to be your conclusions about not having a need for radical change. But if we see the law as enforced by the courts being redefined, then some of those issues may have to be reopened.

Senator WIRTH. My time has expired, Mr. Chairman, but if we might get a fast reaction, if that would be all right, from Dr. Greenspan and perhaps Mr. Fleischman.

Dr. GREENSPAN. The problem probably is already cresting in the sense that it looks as though the major surge in mergers, acquisitions, and a great deal of the type of activity which has created extraordinary interest on the part of the Congress results from the fact that we had a very large premium in the financial markets for control. If you go back to the pre-1980's period, the market value per share of control would tend to sell 20 to 40 percent above the so-called investment value—the value which tended to be struck in the marketplace on a daily basis for 100 share lots, for example.

At 20 to 40 percent above the market there was no great incentive for somebody to go in and try to gain control and reorganize the company. Largely, because of the very high budget deficit and the very large increase in the real cost of capital we tended to change the optimum mix of assets in a particular company, and therefore the incentive to go in, control a company, restructure it, became very valuable.

Television networks whose market value as a share was already matched by the market value of the network owned and operated television stations, not to mention the rest of the types of assets which those companies had.

As a result we drove up the premium for control probably to about 100 percent. And that engendered a great deal of activity. However, the very sharp rise in stock prices in recent months has again closed that gap, and we have already seen some falling off of this activity. My concern is that the Congress will legislate a problem which is already disappearing. And I suspect, as Marty Feldstein has said, that the conclusions you are coming to are probably the right ones.

Senator WIRTH. Well, I will send you a copy of that report and may I get your reaction back? Mr. Fleischman, do you have any comment?

Mr. FLEISCHMAN. Senator Wirth, you have described the report very briefly and very generally. As I understand it, I am in brief and general agreement with it.

Senator WIRTH. Mr. Chairman, thank you very much. Again, Mr. Shad, congratulations to you and Mr. Lynch and your people for your diligent activity. It is appreciated, I think, by not only the Congress but shareholders all across the country that there is a firm hand there. Thank you, sir.

Chairman CHILES [presiding]. Senator Sasser.

LOAN ASSET SALES

Senator SASSER. Thank you, Mr. Chairman. Gentlemen, I suspect that Dr. Feldstein is right when he says it is not a question of if these loan assets are going to be sold, it is a question of when and how many. Given that scenario I think there are some questions which should be asked.

In the view of this panel, are there some loan portfolios which should justifiably be sold, from an accounting perspective, and if so, which ones do you think, we should sell? And are there some loan portfolios that if they are sold—and I think we have already discussed this perhaps to some extent—will actually increase the deficit in future years and which we should hold on to? Does anybody want to address that question?

Dr. GREENSPAN. If the question, Senator, is do we wish to keep the investment in certain various types of assets, I would suspect not. And let me suggest why.

I am not saying that if the Government borrows, say, at 6 percent, and buys assets which yield 8 percent, that it cannot make a profit. It clearly can. If the Federal Government were today to borrow money and invest it in triple-A corporate bonds, for example, of the same maturity, it could lock in a profit.

Indeed, you could create a huge Federal Government portfolio which was profitable. However, that has very serious negative economic effects over and above the issue of the budget deficit. The question, basically, has got to be, other than the issue or the ability of the Federal Government to make a profit because it is the lowest cost borrower, are there any assets in the portfolio which would be held for income reasons? And the answer is no.

To the extent that you sell off any asset, you automatically reduce the Government debt as well. The sole criterion—the sole advantage in holding any Government asset for income purposes rests on nothing more than the fact that the Government is the low-cost borrower. That is a very difficult subject to get into because it rests on a more complex economic question.

But the Government should avoid that because were it to intermediate, it might create income for the Government, but it would also create inflation which would ultimately wipe out the benefits to the society and the economy.

Senator SASSER. Dr. Feldstein, do you want to take a crack at that?

Dr. FELDSTEIN. Well, I think the question is how much or in what order, perhaps, is the best way to put it. If what you want to do is to sell \$5 billion worth, which \$5 billion should you sell. It seems to me there the principle ought to be, where does the private sector have the greatest comparative advantage at enforcement and collection of those loans.

So, as Mr. Shad said before, some of those loans are triple-A. That money is going to come in. I would put those low on the list of things to sell. It is the ones where the market may be a better collection vehicle than the Federal Government—more efficient collection vehicle, both in the sense of getting the money in and also in terms of the resources that it uses to get that money in.

That would be the criteria that I would use. I do not have a ranking of the actual pieces of the portfolio by that criterion, but I think that is the way it ought to be structured. Not what you get the highest return on, not what you take the least discount on. That might be almost the obverse of what you want to do. You want to go for those where the market can bring the most to the party.

Senator SASSER. Mr. Fleischman, Mr. Shad, would you want to comment on that?

DON'T BE SELECTIVE OF LOAN TO SELL

Mr. SHAD. I think there is a danger in so-called cherry-picking a portfolio for liquidation. I have some mixed emotions on this because of the trial nature of what is going on. It is the beginning. It is the starting of something and you have got to, I think, do the best possible job of having a successful initial venture.

And in that respect I would like to amplify a comment I made a moment ago. I mentioned that all we were talking about is \$5 billion and there were over \$80 billion of collateralized mortgage obligations registered with the SEC last year. So in dollar amount it does not pose a big problem, in my opinion, in terms of the market's ability to absorb.

But the real problem here is documentation—which in some cases I understand is virtually non-existent—and terrible collection records where people have really looked on these loans as some sort of a grant that did not have to be paid back. And that will be the problem in implementing this law in the time available—liquidating \$5 billion of, in many cases, extremely soft paper in a period of 8 months.

I think this is an enormous job to be done by the financial advisers, the securities lawyers, and the agencies themselves to come up with the necessary documentation to permit the liquidation. And then I would rely—looking at it from the point of view of the individual agencies and therefore the Federal Government—on the best advice that they will get from the leading firms that are going to be acting as advisers.

They are not going to be competing to buy it. There will be a lot of them out there that will be prepared to make bids on this paper, but first you have got to have it properly analyzed and structured. And I do think they have got some top experts to help them do that.

Senator SASSER. Well, gentlemen, my time is up. Unless you feel a great urgency to respond to this, Mr. Fleischman, we will move on to Senator Simon.

ECONOMICS OF DEFICIT REDUCTION AND WHERE TO GET REVENUES

Senator SIMON. Thank you, and I shall be very brief. I apologize. I have been tied up in another committee mark-up so I have not been here.

One question for all of you, and Dr. Greenspan, in your testimony you say the administration is forecasting a significant decline in the budget deficit, and I will skip some words here, and then you comment, "But the gains are likely to be far short of what is now officially contemplated, either by OMB or CBO."

My belief is this deficit is just a horrendous thing that we have got to get a hold of. To get a hold of it, inevitably you are talking about revenue increases. I just had a discussion yesterday with someone about getting down to this \$108 billion figure. To get there I was told you would need \$20 or \$30 billion in additional revenue. That would depress the economy.

And I guess I have two questions—I said one. Let's just take the \$30 billion figure. Does \$30 billion in additional taxes in a \$3 to \$4 trillion economy really have much significance at all? And number two, if you were to reach out and grab for \$30 billion in additional revenue, where would you reach?

EXPENDITURE REDUCTION/CONSUMPTION TAX

Dr. GREENSPAN. Well, Senator, let me answer the last question first. Were I required to do that, and I do have certain qualms about it, I would certainly stay away from all forms of income tax—corporate or individual—and try to obtain all of it in some form of a consumption tax.

The basic problem in resolving the budget deficit issue really gets down to what is the mix of tax and expenditure reductions involved. I subscribe to Senator Chiles' rough outline earlier in which he specified combinations of expenditure reductions and taxes, all to be going into a single bill which will reduce the deficit. I may actually have expanded a little bit on what he was actually saying.

I think it would be a mistake to try to close the gap wholly from the tax side, because, as I indicated earlier, we would be, in effect, replacing a very serious problem—which is the budget deficit—with another problem, namely the underwriting of the continued rise in Federal outlays as a percent of the GNP.

So, while we would solve one problem in the short run, we would create a much more difficult one, in my judgment, in the longer run. And therefore I think it is important to keep both the issue of expenditure restraint and the issue of closing the deficit in mind in resolving this issue.

Senator SIMON. Assume you have that mix—and I agree, you have to have that mix. We are talking, basically, reducing the deficit \$60 billion to get to the \$108 billion figure. Does a \$30 billion consumption tax, using your example, does that depress the economy?

Dr. GREENSPAN. If it is combined with expenditure restraint, I think that the markets would perceive a very significant long-term improvement in the deficit which would reduce the real cost of capital and probably engender an expansion and capital investment in the private sector which would at least offset the so-called fiscal drag which a lot of analysts are concerned about as a result of the increased taxes.

I must say to you, Senator, I cannot conceive of any package of deficit reduction which is politically feasible which is economically undesirable.

Senator SIMON. That is a very good answer. —

LARGE REVENUE INCREASE DESIRABLE

Dr. FELDSTEIN. I agree with what Alan just said. As I said in answer to earlier questions, that while I might worry about what would happen if Congress somehow moved to \$108 billion in terms of real deficit reduction, I think anything that is feasible politically this year is a step in the right direction in terms of deficit reduction.

Thirty-billion dollars of tax revenue could do a lot of damage if it is the wrong kind of taxes. Taxes have not only an effect of taking demand out of the economy directly, but they also change incentives. And what is really important is to maintain those incentives by not pushing up further marginal tax rates, corporate tax rates, capital gains tax rates, as long as that is possible.

But I would say that \$30 billion of additional revenue, if it came primarily from oil and gas, from alcohol, from tobacco, would be a plus because, exactly as Alan said, the markets would recognize that this was not a one-shot change but was something that was going to persist and that, indeed, I would rather see it phased in over time so that it got even larger in the future. Because the markets would respond to that future impact on the deficit by giving us lower interest rates in the capital markets today, which would actually then be a plus from an economic point of view.

MUST MODIFY INDEXING AS EXISTS

I think there is another proposal which I have made before this committee in the past and I will not pass up this opportunity to make it again, and that is to modify indexing. I think ultimately, if we are looking for a way of balancing additional revenue and reductions in spending, you cannot keep passing up the whole entitlement program. You cannot keep passing up all of the index benefits.

And perhaps one way of casting that as a fair package is to share it between taxpayers and entitlement recipients through a modification of indexing. Nobody's benefits would be cut, tax rates would stay at 15 and 28 percent, but by putting in a CPI minus 2 or CPI minus 3 rule, cumulatively over time that would have a very powerful effect, and I think the psychological impact on the financial markets in the short term would be very great and we would see it in lower interest rates.

Senator SIMON. My colleague, Senator Wirth, just asked me a question that I was wondering when you said on indexation. I know my time is up, Mr. Chairman.

Are you talking only on entitlements, or are you talking about tax rates, also?

Dr. FELDSTEIN. Both.

Chairman CHILES. So you are saying a modification that would affect both?

Dr. FELDSTEIN. In parallel, so they are tied together. And in that sense you could say, this is not a proposal to raise taxes, this is not a proposal that is one-sided, but rather affects both sides; both the outlays and the taxes automatically together.

Senator WIRTH. Just to follow up one more step, what kind of changes in the deficit might result from that?

Dr. FELDSTEIN. If you do the CPI minus 2, the first year you get a relatively small impact. A few years out, \$25 to \$30 billion a year, in the third year. That is a rough calculation. I could give that to you more precisely.

Senator SIMON. I know my time is up, but I think this is important. First of all, you made a suggestion that I have not heard before and that I really like, and that is, in the out-years you plan for additional revenue. So you do something that is politically acceptable and at the same time let the financial markets know that we are serious about dealing with this thing.

Another possibility on the CPI is that we give everybody the full CPI but not compound the benefits. So, you know, if you get \$100 and it is at 3 percent, the next year it is \$103. If the next year it is another 3 percent, it is figured on the base of \$100. It does not provide much difference initially, but down the road it provides some very, very substantial differences.

Most groups I have talked to are not that hostile to that idea. Any reaction?

Dr. FELDSTEIN. Are you sure they understand it? I think I understand what you are saying, so that if I am entitled to an entitlement check of \$1,000 a month, you will raise it by—if inflation is 4 percent, I will get another \$40 in the first year. If inflation is 4 percent the year after, you will take it from \$1,040 to \$1,080, but you will not give me interest on the interest, so to speak.

Senator SIMON. That is correct.

Dr. GREENSPAN. That is the same as the CPI minus something.

Dr. FELDSTEIN. But it is a very small difference.

Senator SIMON. It is, yes.

Dr. FELDSTEIN. In the second year, and even in the third year, you are saving a dollar and a half, or something like that. It is very, very small.

Chairman CHILES. You have to look at it in a few years. In the out-years it makes a lot of difference.

Dr. GREENSPAN. It depends on the inflation.

Chairman CHILES. That's true. You might say it is a very good safe hedge against the danger of high inflation.

Well, we want to thank all of you very much for your appearance here today. I think the testimony from all of you has been very, very helpful to us and we appreciate very much your attendance and your coming. It was a good hearing.

[Whereupon, at 12:20 p.m., the committee adjourned subject to the call of the chair.]

CREDIT AND ASSET SALES

WEDNESDAY, MARCH 4, 1987

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 2:13 p.m., in room SD-608, Dirksen Senate Office Building, Hon. Lawton Chiles (chairman of the committee) presiding.

Present: Senators Chiles, Sasser, Riegle, Exon, Lautenberg, Simon, Conrad, Domenici, Grassley, Danforth, and Nickles.

Staff present: Richard N. Brandon, staff director; and Jim Carr, group leader for tax policy, housing and credit.

For the minority: G. William Hoagland, staff director; and Carol Hartwell, senior analyst for housing and credit.

OPENING STATEMENT OF CHAIRMAN CHILES

Chairman CHILES. This afternoon the committee will examine the administration's credit reform proposals. With us are Joe Wright, the Deputy Director of the Office of Management and Budget; James Blum, the Assistant Director for Budget Analysis at the Congressional Budget Office; Frederick Wolf, the Director of Accounting and Financial Management for the General Accounting Office.

ADMINISTRATION CREDIT REFORM PROPOSALS

The administration's credit reform proposals deserve credit themselves. I see in these proposals a serious attempt to give a more accurate picture of what it costs the Government to borrow and lend money. For the most part, I believe these changes will be helpful.

As things stand now, the way credit transactions are accounted for, or scored, there is little relation to the actual cost to the Government over the long run.

In some ways, we treat a loan the way we treat a grant. A \$100 million loan shows up as a \$100 million expense. Even though the Government expects to get something back on the money it loans, our current accounting practices do not reflect that.

There is another problem. Many Government loans flow through a revolving fund. When a loan is made, we offset it by amounts coming into the fund from other transactions. It makes the cost of the loan look lower than it really is.

Whenever the Government makes a loan, there is a subsidy involved, whether it is because of low interest rates or longer terms

of repayment. The administration's proposals want to pin down that subsidy and show it on the books as a cost to the Government in the first year. That is fine.

But there are several remaining questions.

The Office of Management and Budget describes the proper cost of these loans as a "benefit to the borrower." That is the difference between what a person would have to pay for the loan on the open market and what it costs to get the same amount through the Government.

Where my question comes in is should the Government be charged a cost unique to the private market? The private markets have higher costs, pay taxes and, of course, seek a profit. So I wonder if these additional costs are really things that we should take into account when billing the Government. I hope you will be able to help us on that this afternoon.

I also have some questions about the issue of re-insurance. Among the proposals is to go to the private markets and ask them to re-insure many of the Government loans. I am frankly worried about programs like FHA.

FHA has been out there for decades with a solid reputation backed by the full force of the Government. If we turn around and have the private lenders re-insure FHA mortgages, I wonder what sort of message that will send to the banks, the builders, and the market in general. So I think we need more information on the re-insurance plans.

ASSET SALES AND THE DEFICIT

Generally speaking, I am encouraged by the initiatives I have seen on credit reform, with one glaring exception. Just 2 weeks ago, Martin Feldstein told this committee unequivocally that asset sales do not reduce the Federal deficit.

So I have to ask why, with all these other serious reform proposals, the administration is keeping up the pretense that the sale of existing loans reduces the Federal deficit.

I want to take these credit reforms seriously, so I am a little disappointed when I look down the list and see one of the proposals dressed up in a clown suit. Asset sales are a joke when it comes to deficit reduction.

Gentlemen, let me say once again I am pleased to see the administration making an effort to give us a clear picture of our credit costs. I am encouraged. We want to explore this further with you this afternoon and see what can be worked out to make our accounting as accurate as possible.

Senator DOMENICI. Mr. Chairman, I want to welcome the witnesses this afternoon and thank you for all of your efforts in preparation for this hearing.

This is the seventeenth hearing held by the Senate Budget Committee since the President's budget was released 2 months ago.

We have now reached the point where we must turn to the more difficult task of putting together a budget. As every member of this committee knows, we have less than a month in which to report a budget resolution to the floor.

But I want to commend you, Mr. Chairman, for making time on the schedule to consider the administration's proposal for credit reform.

It is a complex subject that deserves our consideration before we get caught up in the more urgent matters of budget plans and deficit reduction.

The reason we are here today is because everyone agrees that there is a problem in the way the budget handles loan programs. CBO, OMB, and GAO all agree that current practices are deficient.

If anyone should doubt that there is a problem, let me remind you of the proposal to allow Rural Electric Co-ops to refinance Federal debt with new, fully guaranteed loans.

No matter how you feel about allowing these co-ops to refinance, there is no question that it will cost the Government and the taxpayers over the long run.

Yet, under our cash-based accounting system, that change shows up magically as a reduction in the deficit.

Another example occurred last spring when the Appropriations Committee was looking for a way to offset new spending in the supplemental. This was around the time that interest rates had fallen and the demand for FHA mortgage insurance had gone through the roof.

To accommodate that demand, we raised the limit on new guarantee commitments. That is to say, we increased the contingent liability of the Government by \$58 billion.

But because FHA collects fees up front, the appropriators were able to count this as a reduction in the deficit to offset new spending. Another case of congressional magic!

Because the current budget practices obscure the cost of credit programs, we're not very good at controlling them.

For proof, I would point out that we are now \$8 billion over the fiscal year 1987 budget resolution assumptions for direct loans and \$40 billion over for loan guarantees—and no one seems to care.

The President's proposal for credit reform goes a long way toward closing the loopholes in the cash-flow budget. I applaud the administration for including this innovative idea in its budget.

I also believe that Senator Tribble, Congressman Gradison, and Senator Heinz all deserve credit for their part in developing this proposal and forcing it onto our agenda.

While I am favorably impressed by the plan, I also have a number of concerns.

I am concerned that in making the budget more accurate, credit reform may also make it more unwieldy.

I question whether it is appropriate to measure the subsidy value of Federal loan programs in terms of private sector costs.

I am not totally convinced that selling loans and reinsuring guarantees makes sense politically or financially.

And I do not know whether the proposal can or should be incorporated in the fiscal year 1988 budget.

I welcome today's session as a chance to discuss these issues and look forward to hearing the views of our witnesses.

Although we may debate the mechanics, I stand squarely behind the goal of the administration's proposal: to do a better job of judging the cost of loan programs.

I hope that we will not abandon this idea in the normal crush of business. The budget committee is uniquely qualified and well positioned to evaluate this kind of accounting change.

I hope that we will seize the opportunity presented to us by the administration's proposal and improve the budget process.

Chairman CHILES. Thank you, sir.

Before we begin with our witnesses, we are delighted to have Senator Heinz with us. He has introduced legislation on credit reform, and he has been trying to do something about that for a long time. We are delighted to have you before the committee today to give us your wisdom.

STATEMENT OF HON. JOHN HEINZ, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Senator HEINZ. Mr. Chairman, thank you. I will be brief because I know the committee does want to hear from the Administration.

GOVERNMENT AND PUBLIC ADVERSELY AFFECTED BY CREDIT ACTIVITIES

I am delighted, nonetheless, to have this opportunity to testify before the Budget Committee in support of credit reform. It is an issue that is important if only because of the size of Federal credit underwriting activity. More than \$1 trillion of Federal direct, subsidized, or guaranteed credit is outstanding. This affects nearly every sector of the U.S. economy.

Credit reform is also of concern because we have budget accounting rules that totally misstate credit costs. Direct loan costs are overstated for those direct loans because they do not incorporate offsets for future reflows. Guarantees, on the other hand, appear to be costless. Budget comparisons across credit programs or between credit and direct spending programs are, frankly, impossible.

The issue that I hope we will all address is whether these conditions represent a minor problem of so-called "cleaning up the books" of interest only to a few accountants at OMB or CBO, or whether this is a problem which adversely affects the operation of the Federal Government and the welfare of the American people.

I think it is the latter. In a world of unconstrained resources, I might be inclined to say that credit reform was not such an important thing to do or an important enough issue to take on. But because we do, in fact, operate in a world of painfully tight budget constraints in which we constantly face decisions affecting the size and structure of Federal programs, I think it is critical. To make these choices with only the vaguest notion of the costs involved is to serve our constituents and our national priorities very poorly, indeed.

For this reason, I believe it is essential that we must address credit reform not as some kind of interesting sidelight of the 1988 budget process, but as a crucial element of our efforts to control the Federal budget deficit.

POINTS OF NEW CREDITS LEGISLATION

Based on my analysis of the credit problems, I have introduced the Federal Credit Program Revolving Fund Act, S. 218, Mr. Chairman, to establish a new budget mechanism for dealing with credit.

I will only take a moment to describe the central principles of the proposal.

First, my proposal would establish the net present value of the subsidy of Federal credit as a uniform cost measure for all Federal credit programs incorporating future reflows and guarantee claims into cost estimates.

Second, my proposal would also create a Federal credit program revolving fund in the Treasury Department to accept subsidy payments, fund credit flows, and provide oversight on pricing of subsidies and credit management improvements.

Third, individual credit programs would seek appropriation of the subsidy required to support their credit activity and transfer subsidy dollars to the Treasury fund.

In implementing credit reform, Mr. Chairman, by whatever vehicle we choose, we must ensure that reform neither reduces the size nor modifies the mandates otherwise established by Congress for Federal credit programs; and it must be deficit-neutral.

While my proposal would reassign some costs, the subsidy assigned to the program and the financing cost to the Treasury, it would not alter the size of the budget deficit.

The final element of credit reform I would like to address is asset sales. There may be circumstances in which sale or re-insurance would be appropriate, but our fiscal year 1987 experience with asset sales argues for a "go-slow" approach. The administration is proposing only a limited program, but I believe that even that program must be carefully reviewed by the Congress.

Mr. Chairman, I believe that my bill represents a good starting blueprint for workable credit reform—reform that is especially critical as we continue to face difficult program choices, the ones particularly, Mr. Chairman, that are necessary to reduce the budget deficit. We must ensure our efforts at control result in sensible budget choices and intended deficit reductions rather than illusory savings.

I urge the committee to carefully look at that proposal, and I know that you will. Thank you, Mr. Chairman.

Chairman CHILES. We certainly shall, and we thank you very much for your appearance here today.

Senator DOMENICI. Mr. Chairman, might I also thank Senator Heinz not only for his testimony here today, but for the leadership he has shown in an effort to help the Congress with its budgetary practices in this area of credit. I am not sure we are going to be able to accomplish all the reforms this year, but I personally want to thank you, Senator Heinz, for all the efforts you have put forth in this regard.

I am positive that before too many more sessions get behind us we are going to have some major reform, and you can take a great deal of pride and credit when it occurs. Thank you for coming today.

Chairman CHILES. Thank you very much for your appearance.
[The prepared statement of Senator Heinz follows:]

STATEMENT OF SENATOR HEINZ



Mr. Chairman, I am delighted to have this opportunity to testify before the Budget Committee in support of credit reform. There is no need for me to impress upon the Members of this Committee the magnitude of the credit management problem facing the Federal government. In the President's 1988 Budget, we are informed that more than one trillion dollars of Federal or federally assisted loans are outstanding, and another \$200 billion of credit activity is proposed during 1988. Through these credits, the government plays a direct role in almost every sector of the U.S. economy including agriculture, housing, education, small business, and exporting.

Beyond the sheer magnitude and reach of the programs, Federal credit activity is characterized by an absolutely mind-numbing array of revolving funds, public corporations, and other budget mechanisms. Budget accounting rules misstate credit costs by recording direct loan disbursements as current year costs that do not incorporate offsets for future reflows. Direct credit costs are therefore overstated. Zero cost is recorded for guarantees -- until a cash payment is required for defaults in future years -- effectively placing guarantees off budget. Without a common "cost denominator," budget comparisons across credit programs or between credit and direct spending programs are impossible.

Overall, then, we have a set of large and complex Federal programs that are poorly managed in the budget process. To the extent that popular programs are shielded from budget pressures, their supporters can breathe a sigh of relief. On the other hand, budget critics see the credit budget as "a triumph of creative accounting" in which gimmickry is used to maximize government assistance while hiding the costs.

The issue we must address is whether these conditions represent a minor problem of "cleaning up the books" -- of interest only to a few accountants at OMB and CBO -- or whether this is a problem that adversely affects the operation of the Federal government and the welfare of the American people.

In a world of unconstrained resources, I might be inclined to say that this is not a very important issue to take on. In such a world, if we do a little more or less of some worthwhile Federal credit activity at the margin, what is the real harm?

However, we are operating in a world of painfully tight budget constraints. Over the last five years, we have been forced to make many unpalatable choices among programs. And these constraints and choices are becoming tighter and more difficult year by year. What is most troubling to me is that we have made choices that have restructured vast areas of Federal credit activity with only the vaguest notion of the cost involved.

In the search for budget savings, we have cut back or eliminated loan programs to achieve largely illusory savings. For example, we have all but eliminated support for exports through the Export-Import Bank direct loan program -- cutting the program more than eighty percent -- to free up \$4.6 billion of room in the budget. In fact, the subsidy cost of Exim loans is only about fifteen cents on the dollar so we have sacrificed a vital export promotion program at a time of record trade deficits in return for a small fraction of promised savings.

I fear that we have made many other choices that have poorly served our constituents. And we will continue to make such choices until some sense is made of our credit budget. For this reason, I believe it is essential that we must address credit reform not as an interesting sidelight of the 1988 budget process, but as a crucial element of our efforts to control the budget deficit.

Successive Administrations and the Congress have attempted to bring credit programs under control and into the budget process -- creating the Federal Financing Bank in 1974 and the Federal credit budget in 1980, and passing Gramm-Rudman in 1985. None of these past reforms has proven effective at gaining full control of Federal credit activity or permitting sensible choices among programs. I believe these efforts have failed for lack of a uniform, meaningful cost measure for credit programs that can be compared to direct spending programs in the unified budget.

As a result of my analysis of the credit problem, I have introduced the "Federal Credit Program Revolving Fund Act" -- S.218. This bill would establish a new budget mechanism that has been incorporated in concept, if not in all details, in the Administration proposals you will hear about today. Since you will shortly explore technical details of credit reform with budget experts, I will not take up your time to explore these issues myself. I would, however, like briefly to describe the central principles of my reform proposal.

First, the proposal would establish a uniform cost measure for all Federal credit programs that would reflect future reflows and claims and serve as the basis for their budget accounting and appropriations. This could be achieved by measuring the "net present value of the subsidy" of a credit by comparing it to a market credit, or measuring its "net present cost to government" by comparing it to the government's cost in funding the credit. Frankly, a shift to either cost basis as a uniform measure would be an improvement. However, I have based my proposal on the net present value of subsidy because of several advantages this measure enjoys.

The net present value of the subsidy is an accurate measure of economic cost of credit programs, and since it represents the "grant element" of a credit, it provides a valid basis for comparison of benefits received under grant, loan, and guarantee programs that a "cost to government" approach would not. It avoids anomalies of a "cost to government" approach in which the net present cost calculation for credit programs with interest rates below market rates but above Treasury's cost of borrowing would yield not a net subsidy cost paid by government but a net benefit to government for operating the program. In these cases, any incentive for controlling Federal credit activity would disappear. Finally, under appropriate circumstances, the subsidy can be accurately measured through sale and reinsurance of Federal credits in the private market.

A second key element of my proposal is creation of a new mechanism to accept subsidy payments, fund credit flows, and provide oversight on pricing of subsidies and credit management improvements. A Federal Credit Program Revolving Fund would be established in the Treasury Department to raise funds for direct credit disbursements and guarantee claims. Under my proposal, individual credit programs would seek appropriation of the subsidy required to support their credit activity. As credit was extended, the program would turn over the appropriate amount of subsidy dollars to the Treasury Fund as payment for the Fund's assuming responsibility for handling loan financing, guarantee claims, and the like. The Fund would play an oversight role in the complex task of establishing subsidy estimates.

In instituting reform, great care must be exercised to ensure that reforms neither reduce the size nor modify the mandates otherwise established by Congress for Federal credit programs. These mandates and independent functions of individual credit programs must not be altered -- only their pricing in the budget.

Another principle I believe is important to successful reform is deficit neutrality. Absent asset sales and reinsurance, the reform I am proposing would make no change in the calculation of the budget deficit. The assignment of costs would change -- with the subsidy assigned to the individual credit program and financing flows assigned to the Treasury Fund. But no costs would shift off budget and the bottom-line calculation would remain unchanged. Even with the assets sales proposed by the Administration, the Administration's plan would also be essentially deficit neutral over the budget planning period.

The final element of credit reform I would like to address is asset sales. While asset sales and reinsurance are presented as the centerpiece of the Administration's credit reform proposal, I view them as useful to, but separable from, basic budget reform. My bill notes that there may be appropriate circumstances in which sale or reinsurance should be used to get an accurate measure of the subsidy. There may also be cases in which shifting credit management to the private sector will result in greater efficiency of debt servicing and reduce the administrative burden on government. On the other hand, as we have seen in the sale of existing assets approved in the FY 1987 Reconciliation, this is a very complex business.

I agree with the view expressed by a Treasury official in a recent National Journal article on credit reform. "Treasury's position is that loan asset sales are going to be a tricky and complicated business. It is important to make sure that the government doesn't sell at less than fair value, doesn't leave people screaming about unfair sales, and so on. The only way to sell loans is one step at a time." I was glad to see in the President's Budget that the Administration has recognized the complexity of the problem and adopted a judicious approach to sales.

Most direct credit programs have been explicitly excluded from sale based on programmatic or foreign policy considerations. Sales and reinsurance are being phased in only slowly. I believe that even this gradual process must be reviewed very carefully by the Congress to ensure that credit program goals and objectives are fully protected. I note, for example, that Export-Import Bank loans that are both administratively complex and raise many of the same foreign policy concerns as excluded foreign aid programs are included in the sales program. We will want to review this and similar cases.

Mr. Chairman, I believe that my bill represents a blueprint for workable credit reform -- reform that is long overdue. It is especially critical as we continue to face difficult program choices necessary to reduce the budget deficit. We cannot permit programs to enjoy an advantage or suffer a disadvantage in budget tradeoffs because costs are hidden or inaccurately represented.

I know some will oppose the type of reform I am proposing because of the difficulty of developing accurate subsidy estimates. I disagree very strongly with this viewpoint. First, we know the current budget costs are wrong. A convincing argument can be made that any estimation improvements of this kind will be an improvement. Second, difficult estimation problems are the stock in trade of budgeting and these calculations would not add undue complexity to the process.

We must improve our control over Federal credit, and we must ensure that our efforts at control result in sensible budget choices and intended deficit reductions rather than illusory savings. I urge your support for a comprehensive effort to improve our credit control system, and I look forward to working with you and the Administration to implement needed reforms.

Chairman CHILES. We will start with Mr. Wright to give us the Government's position on this.

STATEMENT OF JOSEPH R. WRIGHT, DEPUTY DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. WRIGHT. Thank you, Mr. Chairman. I am delighted to be here today to discuss the administration's proposal to reform the way credit programs are managed within the Federal Government. I would like to emphasize managed rather than just scored within the Federal Government.

TRILLION DOLLAR MANAGEMENT PROBLEM

I think that what we are talking about, as Senator Heinz mentioned, is a trillion dollar management problem which often has been overlooked because of the way credit programs have been scored in the budget, often by the Budget Committees and the Appropriations Committees, and it particularly has been exacerbated by the trend that we have seen to go from direct lending—which is normally scored at the time that it is made up against the deficit—and guaranteed lending—which, as Senator Heinz mentioned, is often considered to be a free good. But it does come back, and it does bite us, and it is very expensive, and it does handle credit in such a way where, by the time that we receive that guarantee back in, often it is in such a delinquent stage that it is almost a lost cause, and we just write it off.

I would like to submit my testimony for the record, if I may, and just highlight some of the points that I think are important, that I think are worth discussing.

Chairman CHILES. Your testimony in full will be included in the record.¹

Mr. WRIGHT. At the end of fiscal year 1986, the Federal Government held \$252 billion in direct loans and \$450 billion in guaranteed loans. If you combine this with the \$453 billion that the Government-sponsored enterprises are responsible for, then we are talking about over \$1.1, \$1.2 trillion.

The credit reform proposal that we have come up with in the administration will complement the improvements that are already being made in the organization, servicing and disposition of Federal credit. I would like to go into those in a little bit more detail before I complete my summary.

I think the proposal will also, and importantly, permit Congress and the administration together to consider credit and direct spending programs on an equal basis, which they have not been able to do in the past. This is the administration's first endorsement, I believe, of a credit reform plan.

CREDIT IN THE BUDGET

The present budgetary treatment of these credit programs are an inaccurate measure of their cost, and they are an ineffective means of control. Whereas the present budget records the true cost of Federal purchases, grants and transfers, it does not do so for credit.

¹See p. 193.

Because of the inadequacies of the present budgetary treatment for recording these credit transactions, a separate credit budget had to be created to record and to place some limitation on the volume of new direct loan obligations and new guaranteed loan commitments.

The problem is it does not show the size of the subsidy or the expenditures. It simply—the credit budget, that is—shows the total volume of credit assisted. Moreover, this credit budget is separate from the unified budget, which is, I believe, one of the problems that we have got in controlling not only the budget process, but also in the management of loan programs.

CREDIT REFORM PROPOSAL

The inadequacies of current budgeting for credit have been recognized in two bills that I am aware of that the Congress considered during the past few years. Several versions of the "Market Plan," as it was called, were proposed by Senator Tribble and Congressman Gradison, and I believe have many good aspects to them. The administration did not back those plans at the time, but we have taken what we call the best aspects of those along with the proposal that Senator Heinz came up with called the "Appropriations Plan" to form what we are now proposing.

And I might say that the proposal that Senator Heinz had come up with is not much different than the one that the administration is now proposing to the Congress.

The administration feels that this proposal is a good way to address the current shortcomings of the budget accounting for credit programs.

Now, I believe it is important at this point to dispel any misunderstandings about the proposal. First, there is nothing in the credit reform proposal that alters the credit programs that the Congress has enacted or changes the existing authority of agencies to operate those credit programs.

Second, it does nothing to alter the Congress' discretion to establish the amount of loans or the guarantees that may be granted.

Third, it does nothing to alter the existing legal or contractual rights of the borrowers.

Fourth, the proposed budgetary treatment of credit affects the deficit only to the extent—and I would like to emphasize only to the extent—that loan assets are sold and guaranteed loans are re-insured. The "scoring" of the administration's credit reform proposal in itself is intended to be deficit-neutral.

Therefore, credit reform uses loan asset sales and guaranteed loan re-insurance as a tool to help establish the true value of Federal credit programs and as a vehicle to use the private sector to manage collections. Again, the primary purpose of the loan sales is not to reduce the deficit. The primary purpose is for good budgeting and good credit management.

I was asked the question, Mr. Chairman, would we support credit reform with loan asset sales and guaranteed loan insurance, even if it had no impact on the deficit at all? The answer, very clearly, is yes, we would. We think it is the way to go.

SUBSIDIES: KEY TO CREDIT REFORM

Now, as part of our proposal, a new Federal credit revolving fund would be established within the Treasury Department, and in fiscal year 1988, out of \$11 billion that we have identified in direct loan disbursements that we think are appropriate to be included, we plan to sell about \$4 billion. In the same year, out of \$176 billion in guaranteed loan commitments, we plan to re-insure about \$8 billion at a cost of about a half a billion dollars.

In closing, I would like to say that this plan again—and I would like to emphasize this—is part of a larger integrated effort to improve the management of Federal credit programs. Prior to the initiation of many of the administration's programs to try to get a handle on Federal credit and the way it is managed, we found that there was an emphasis in the agencies on making the loans, not necessarily collecting them.

We had to start from scratch on the Federal credit programs. First, we did develop early on an overall policy for Government-wide credit management. Then we were able to work very effectively with the Congress in a cooperative way to give agencies the tools they previously lacked. They had too many restrictions against good credit management to be able to get on top of handling a trillion dollar portfolio.

The Debt Collection Act in 1982 was an important advance. It authorized us to use credit bureau reports to screen those applying for Government credit and also to contract with private collection agencies to collect the delinquent debt.

Then in 1984, the Deficit Reduction Act authorized income tax refund offsets, and just last year the Federal Recovery Act gave the Attorney General authority to contract with private attorneys. These were all extremely important tools for us to use in getting a little bit on top of this massive portfolio.

FACTORS CONTRIBUTING TO DELINQUENT DEBT

Now, a little bit of a credit card, if I can, on the credit program, Mr. Chairman—sorry for the pun. Since 1981, just to set the stage, delinquent debt owed the Federal Government has increased from \$29.8 billion to \$68.3 billion. Now, four factors contributed substantially to this increase.

First, the rapid growth of Government credit budgets in the 1970's. Outstanding credit tripled from \$200 billion in 1970 to \$600 billion in 1980.

Second, given the state of the economy in 1980 with its 12.8 percent inflation rate, lenders and borrowers both began basing economic decisions on the assumption that inflation would continue. And they were unprepared at that time for inflation to come in at a much lower figure and change the economics.

Third, Federal credit management programs were not adequate to halt the rising delinquent debt.

And fourth, delinquent tax debt increased by \$24.1 billion, or 136 percent in the 1980's. It represented about 60 percent of all delinquent debt owed the government.

Progress has been made, though, in terms of reducing that annual rate of increase in delinquencies from 44 percent in the

1981-82 period to 15 percent in 1985 and 1986. But for most Federal agencies there has been virtually no growth at all in delinquent debt since 1982.

And I would like to say that this finding is the result of a concentrated program that the administration and the Congress has been working on, to make sure that credit management takes a front seat as well as budget management within the entire federal establishment.

That is a summary of my testimony, Mr. Chairman. I would be more than happy—I assume that the other two members up here will give their testimony and answer whatever questions you may have. I would like to emphasize, Mr. Chairman, that we do not have all of the answers, by no stretch of the imagination. We have tried to propose, along with loan asset sales, a moderate program where we learn as we go along. We do know, though, that the time is now to be able to go on ahead and start putting in some reforms, to where we can properly evaluate credit programs against other spending programs, and have the flexibility to use the strength of both the Federal collection techniques and the private sector techniques for the benefit of the taxpayer.

Thank you very much.

Chairman CHILES. Thank you very much, Mr. Wright.

[The prepared statement of Mr. Wright follows:]

PREPARED STATEMENT OF
JOSEPH R. WRIGHT
DEPUTY DIRECTOR
OFFICE OF MANAGEMENT AND BUDGET
before the
SENATE BUDGET COMMITTEE
UNITED STATES SENATE
WASHINGTON, D.C.
MARCH 4, 1987

Mr. Chairman and Members of the Committee: I am pleased to be here today to discuss the Administration's proposal to reform the way credit programs are managed in the Federal Government. This proposal is an important addition to the President's overall plan to improve the management of Government programs. (In FY 1986, the Federal Government disbursed \$42 billion in new direct loans and provided \$159 billion in loan guarantees. At the end of FY 1986, the Federal Government held \$252 billion in direct loans and \$450 billion in guaranteed loans.) The credit reform proposal will complement the improvements that are being made in the origination, servicing, and disposition of Federal credit. Most importantly, the proposal will permit the Congress and the Administration to consider credit and direct spending programs on an equal basis.

Although Congress has proposed various ways to reform Federal credit programs in the past few years, this proposal represents the Administration's first endorsement of a credit reform plan.

Let me explain the problem we now face with credit programs and how credit reform will help to solve it.

Credit in the Budget

The present budgetary treatment of Federal credit programs results in an inaccurate measure of their cost, an inappropriate guide to the allocation of resources, and an ineffective means of control. Whereas the present budget records the true cost of Federal purchases, grants and transfers, it does not do so for credit.

- o For direct loans, the present budget measures net cash flow -- the new loans to borrowers (and any interest paid) minus interest received and repayments of previous loans which could have been made 20 or more years ago. This is misleading in four ways:

- (1) the gross disbursement of new loans overstates their cost to the government because the government now owns a financial asset with market value which is not recorded as being of value;
 - (2) the fact that loans are expected to be repaid leaves the impression that, over time, they are costless, but this is not so because Federal credit programs provide subsidies to borrowers;
 - (3) the subtraction of repayments on previous loans confuses the effect of current decisions; and
 - (4) the budget accounts do not contain information on how much of the new loan is a financial asset and how much is a subsidy or expenditure.
- o For loan guarantees, the present budget does not record any costs unless and until defaults occur. At the time the commitment to guarantee is made, a loan guarantee is considered a free good when compared with either a grant or a direct loan.

Because of the inadequacies of the present budgetary treatment for recording credit transactions, a separate credit budget was created to record and to place some limitation on the volume of new direct loan obligations and new guaranteed loan

commitments. The credit budget has the advantage of focusing attention on the decisions that commit the Government to new expenditures. But it does not show the size of the subsidies or expenditures; it shows the total volume of credit assisted. Thus it does not distinguish between programs with deep subsidies, like the P.L. 480 export credits program with a 95 percent subsidy, and those with smaller ones, like the Rural Electrification Administration's loans to electricity distributors with a 4.8 percent subsidy. Moreover, the credit budget is separate from the unified budget, so that tradeoffs between credit and other spending cannot be made.

Credit Reform Proposal

The inadequacies of current budgeting for credit have been recognized in two bills that the Congress considered during the past few years. Several versions of the "Market Plan" were proposed by Senator Tribble and Congressman Gradison. The later versions of the bill simplified the original proposal by modifying the requirements to sell all newly issued and existing loans and to reinsure all new loan guarantees. The "Appropriations Plan" proposed by Senator Heinz would estimate the true cost of credit programs and require agencies to request appropriations for them; it would create a central revolving fund for the unsubsidized portions of direct and guaranteed loans.

The Administration's credit reform proposal builds on the ideas put forward in those two bills in order to improve the way credit is treated in the budget. The proposal would:

- o measure accurately and equitably the benefits and subsidies of Federal credit programs;
- o put the cost of direct loan credit programs on an expenditure basis equivalent to other Federal spending;
- o recognize the cost of guaranteed loans at the time these loans are made;
- o encourage delivery of benefits in the form most appropriate to the needs of beneficiaries; and
- o improve the allocation of resources among credit programs and between credit and other spending.

As you can see from these objectives, the credit reform proposal has been designed as a way of addressing the current shortcomings of budget accounting for credit programs. It would change the present system of scorekeeping for credit programs and give both members of Congress and the Administration better information to evaluate the costs and benefits of Federal credit programs.

It is important at this point to dispel any misunderstandings that may exist about our proposal.

- o Nothing in credit reform alters the credit programs that the Congress has enacted or changes the existing authority of agencies to operate credit programs. Agencies will continue to arrange and approve direct loans and loan guarantees in the way they do now.
- o It does nothing to alter the Congress's discretion to establish the amount of loans that may be granted. What it does do is to put the budgetary resources provided to credit programs through the appropriations process on an equal footing with the budgetary resources provided to other programs.
- o It does nothing to alter the existing legal or contractual rights of the borrowers.
- o The proposed budgetary treatment of credit affects the deficit only to the extent that loan assets are sold and guaranteed loans are reinsured. The "scoring" of the Administration's credit reform proposal is itself deficit neutral.

- o Credit reform uses loan asset sales and guaranteed loan reinsurance as a tool to help establish the true value of Federal credit programs and as a vehicle to use the private sector to manage collections. The primary purpose of the loan sales is not to reduce the deficit -- it is for good credit management. Indeed, the deficit savings achieved by loan asset sales are increasingly offset by the loss of payments of principal and interest as well as by outlays for the purchase of reinsurance for guaranteed loans. In sum, we would support credit reform with loan asset sales and guaranteed loan reinsurance even if it had no impact on the deficit at all.

Subsidies: Key to Credit Reform

A new Federal credit revolving fund would be established within the Treasury Department. In addition to funding loans and overseeing the sale of direct loans and the reinsurance of guaranteed loans, a major responsibility of the fund is estimating the subsidies for agency loans.

A large part of the ultimate success of this plan depends on the ability of the fund to establish correct subsidy values for direct loans and loan guarantees. The subsidy estimate should provide a measure of the grant-equivalent costs of the current period loan obligations and guarantee commitments. One way to

estimate that subsidy is to sell the direct loans or reinsure loan guarantees. This approach would determine the grant-equivalent costs of a direct loan by comparing the market value of the loan with its face value. The grant-equivalent costs of a loan guarantee would be measured as the cost of getting the private sector to assume the liability, i.e., the cost of reinsurance. If loans are sold or reinsured, then all aspects of the loan are taken into account -- administrative costs, cost of capital, default risks, after-tax return on investment, availability of credit, and statutory forbearance provisions.

However, it is not necessary to actually sell or reinsure all loans to estimate the grant-equivalent costs. It is possible to estimate the cost of comparable loans made in competitive markets by reviewing data that are available from private sector loan transactions. Although this approach is subject to a margin of error, it has the advantage of avoiding problems that arise in selling or reinsuring certain types of loans. Our credit reform proposal would estimate subsidies by using a mix of actual loan sales and reinsurance with estimates made by the fund using private sector loan data. For example, in FY 1988, out of \$11 billion in direct loan disbursements we plan to sell \$4 billion. In the same year, out of \$176 billion in guaranteed loan commitments, we plan to reinsure about \$8 billion at a cost of \$0.5 billion.

How the Plan Would Work

I will now describe how credit transactions would occur and be measured for direct loans and guaranteed loans under the credit reform proposal.

For direct loans:

- o Federal agencies would be required to obtain appropriations equal to the estimated grant-equivalent subsidy of the direct loans they make.
- o An agency would continue to accept and process applications for new direct loans as it does now. As loans are disbursed to recipients, the agency would pay the fund for the subsidy represented by those disbursements. That subsidy payment would be recorded as an outlay of the originating agency. The fund itself would provide the unsubsidized balance of the loan amount through the use of its permanent indefinite budget authority.
- o Direct loans would be sold to the public or be held by the fund if they were exempt from sale. If the loans were sold, the sales would be made on a nonrecourse basis and the collections from the sale would be an offsetting collection to the fund. If the loans were

held, the agency would service the loan on behalf of the fund. Principal and interest payments received by the agency would be forwarded to the fund.

- o Not all direct loan programs will be included in the credit reform proposal. Those excluded are the CCC commodity loan program, which is more of a commodity purchase program than a credit program, and direct loans that result from defaulted guaranteed loans, which are more of an extension of the loan collection process than they are new loans. In addition, several programs will be included in the credit reform proposal but will be exempt from requirements to sell loan assets. For example, international loans with foreign policy ramifications and loans made by financial regulators will not be required to be sold. The actual decision about which loans to sell and which to hold should be left to the discretion of the Secretary of the Treasury or his representatives, who are the officials with ultimate responsibility for operating the fund, subject to normal Office of Management and Budget review.

For loan guarantees:

- o Federal agencies would be required to obtain appropriations equal to the estimated grant-equivalent subsidy of the loan guarantees they make.

- o Agencies would continue to accept and process applications for new guaranteed loans as they do now. At the same time as a guaranteed loan is issued by a lender, an agency would pay the fund for the subsidy represented by that loan. The subsidy payment would be recorded as an outlay of the originating agency. This procedure means that, for the first time, loan guarantees would require the use of budgetary resources. The agency would also transfer to the fund the fees paid by the borrower.
- o Guaranteed loans could either remain a contingent liability of the fund or be reinsured with the private sector. If reinsured, the cost of reinsurance would be an outlay of the fund and the cost of any future defaults would be borne by the private reinsurer. If the loans were held by the fund, they would continue to be insured by the Government. The subsidies and fees, plus the interest thereon, would constitute a reserve; the cost of any future defaults would be borne by the fund.
- o All guaranteed loans are scheduled to be reinsured, but the program will be phased-in over a 5-year period in order to allow the reinsurance industry to develop. We believe that as the insurance industry becomes more

familiar with the type of risks guaranteed by the Government, reinsurance markets will develop for the full range of Federal guarantees. In fact, we assume that nearly all federally guaranteed loans can be reinsured by 1992. In 1988, we have limited the purchase of reinsurance to a portion of the housing and student loans guaranteed by the Government. Meanwhile, the Working Group on Federal Credit Policy will be developing guidelines for reinsuring loan guarantees as well as looking into how to improve the collections process.

Functions of the Fund

As I said earlier, a Federal credit revolving fund would be created within the Treasury Department. Treasury would assume the following administrative functions in order to implement credit reform:

- o Establish an automated accounting and control system to keep track of the status of the fund's lending activity and ensure that agency credit activity is limited to the amounts appropriated for subsidy costs.
- o Estimate the subsidy value for loans so that the program agency can request appropriations for the subsidy amount.

- o Provide oversight of loan asset sales that will be conducted by program agencies. However, Treasury would have permissive authority to make such sales itself.
- o Provide oversight of insurance purchased from private insurers that will be done by program agencies. However, Treasury would have permissive authority to purchase such insurance itself.
- o Hold as collateral any assets that result from the default of borrowers. Treasury would oversee the liquidation of such collateral by program agencies, although Treasury would have permissive authority to sell such assets itself.

The credit revolving fund would be separate from the Federal Financing Bank (FFB) and the FFB will be gradually phased-out as the loans it currently holds are repaid.

An Integrated Effort to Improve Credit Management

As I noted at the beginning of my testimony, the credit reform proposal is part of a larger, integrated effort to improve the management of Federal credit programs.

This committee recently heard testimony about the Administration's plans to sell existing loan assets, so I don't want to take much more of your time on that issue. But I would like to observe that the asset sales program was created primarily to improve the way Federal agencies administer their credit programs, and I believe that some benefits have already come from it even though no sales have occurred yet. For example, prior to the initiation of the Administration's pilot program for loan asset sales, documentation of loans -- the simple keeping track of who owes what and how much has been repaid -- was frequently neglected. Documentation on nearly 60% of the Department of Education's facilities loans could not be found. Similar problems existed for the loans held in the 2,000 Farmers' Home Administration offices around the country. These problems have been corrected already. The financial advisors that we have contracted with as part of the pilot program know what is required and are teaching the agencies what they need to know to assure that the sales are conducted in a professional manner designed to achieve the highest returns to the Government. By continuing this process, we will reduce the Government's cost of operating credit programs and cause agencies to upgrade their techniques of loan origination and documentation.

Credit reform can also be regarded as an adjunct to other credit management improvements. In 1981, the Reagan Administration inherited large loan programs where credit and debt collection management was nonexistent. Credit was extended

to farmers, homeowners, students, small businessmen, exporters and local, State and foreign governments with little emphasis on repayment. There was no centralized policy guidance to promote effective loan servicing or foster timely collections. Federal program managers devoted their time to loan disbursement rather than the collection of debt. Agencies lacked the tools to employ acceptable debt collection practices. Automated information and processing systems were almost nonexistent, and program managers were forced to rely on antiquated manual systems. Specific legislative authority was lacking, so agencies could not use such long-established private sector resources as private collection agencies and credit bureaus.

The Reagan Administration accepted the challenge of improving the management of the Government's unwieldy financial portfolio as soon as it assumed office. We had to start from scratch.

- First, we developed an overall policy for Government-wide credit management and established an accurate and reliable statistical base for tracking progress and basing decisions.
- Congress and the Administration joined in a cooperative effort to give agencies the tools they had previously lacked. The Debt Collection Act of 1982 authorized use of credit bureau reports to screen those applying for

Government credit and empowered agencies to contract with private collection agencies to collect delinquent debt. In 1984, the Deficit Reduction Act authorized income tax refund offsets, and just last year the Federal Debt Recovery Act gave the Attorney General authority to contract with private attorneys to assist the Justice Department in delinquent debt litigation.

- In August 1986, Office of Management and Budget Director Jim Miller announced a Nine-Point Credit Management Program which requires all agencies to fully implement effective credit management and debt collection programs. We have just negotiated specific performance goals for each major credit agency to assure achievement of the Nine-Point Program.

Six years of hard work have begun to pay off. Credit management has improved dramatically in many agencies and our performance goals process will assure continuing progress. However, more is needed. We have now reached the point where fundamental change is needed if we are to achieve a lasting reform of Government credit management. The incentives in the system must be changed from encouraging just giving money away to assuring that the best loans possible are awarded to achieve most fully the statutory purposes of Federal loan programs. Loan asset sales are a major step in that direction. They force agencies to recognize the tie between awarding a loan and the

price they will receive in the marketplace. They force agencies to face up to the need to assure that each and every loan is fully and properly documented.

But, loan asset sales are important not only because they force agencies to remedy past problems, but because they pave the way to the future of credit reform. They do so through establishing an accurate, marketplace-established subsidy rate for the Government's loan programs -- a precondition for credit reform. They also place responsibility for collection of debt where it can best be handled -- in the private sector.

Our overall plan for credit can be thought of in this way: credit reform will give us better information about the credit programs that we administer, and both loan asset sales and the credit management improvement initiatives will enhance the operation of those programs. In short, these efforts are designed to make better use of the taxpayers' dollar when it comes to Federal credit.

Mr. Chairman, thank you for hearing my views on this important and complicated proposal. I hope I was able to communicate that this proposal is an attempt to substantially improve the management of our Federal credit programs -- not to simply reduce the deficit. This concludes my prepared remarks. I would now be happy to answer any questions you or the Members of the Committee may have.

Chairman CHILES. Mr. Wolf.

STATEMENT OF FREDERICK D. WOLF, DIRECTOR, ACCOUNTING
AND FINANCIAL MANAGEMENT DIVISION, GENERAL ACCOUNT-
ING OFFICE

Mr. WOLF. Thank you, Mr. Chairman. I am pleased to be here today to discuss the administration's plans for improving management of and budgeting for Federal credit assistance activities. Since Joe and the Senator have talked about the administration's plans already, let me just summarize the areas where we have specific views, and submit my full statement for the record.

GAO'S VIEWS ON ADMINISTRATION PLAN

We believe there is a need to better manage our credit activities. Our studies of debt collection have indicated that this is an area where, as a government, our performance has not been very good. The credit reform program may well help to improve our performance both in collecting debts and also in getting better documentation and better loan accounting records. Secondly, we believe that the budgetary accounting for loan programs should be changed to reflect the cost of these programs, rather than charging the full amount of the loan against the deficit in the year the loan is made.

We also support a related change in guarantee account to reflect cost.

We have concerns in three areas. The administration's proposal deals with loan subsidies based upon the subsidy benefit provided to the borrower. We believe that the subsidy calculation should reflect the cost to the Government, rather than the benefit to the borrower.

Secondly, we believe the requirement to sell loans promptly and without recourse, and the requirement to sell all loans, may not be in the best interest, financially, of the Government. In talking about recourse, however, we would note that we are not necessarily supporting full recourse, but rather a judicial use of partial recourse where warranted.

We need to be very careful in any program where we sell loans, that we insure that borrowers are not adversely affected in regard to their rights under their own agreements.

Fourth, while we support appropriate sale of loans, we would emphasize that this is not a solution to the deficit problem.

And lastly, we believe that considering the magnitude of the amounts involved and the amounts that will be flowing through the proposed revolving fund, accountability and financial reporting is highly important.

We believe that financial statements of the funds should be prepared and that they should be audited by an independent auditor. Thank you very much.

Chairman CHILES. Thank you very much Mr. Wolf.

[The prepared statement of Mr. Wolf follows:]

GAO

United States General Accounting Office

Testimony

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Proposals for Improved Credit Program Budgeting

Statement of
Frederick D. Wolf, Director
Accounting and Financial Management Division

Before the
Committee on the Budget
United States Senate



Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present our views on the administration's plans for improving the management of, and budgeting for, federal credit assistance activities. It is encouraging to see steps being proposed to improve the way the government administers and budgets for its credit activities. We have long held that improvements are needed in these areas. With new direct loan obligations running at about \$40 billion a year, and annual new loan guarantee commitments at about \$160 billion, the government certainly needs procedures that fully disclose the costs and provide for adequate congressional controls.

Until a credit reform bill is presented by the administration, we will not know the final details of their proposal. However, I can address the administration's general approach as set forth in the President's budget for fiscal year 1988, and elaborated on in some materials provided by the Office of Management and Budget (OMB).

SYNOPSIS OF THE ADMINISTRATION'S PROPOSAL

The key objectives of the proposal are to:

- reduce the government's costs of managing credit programs,
- provide incentives to federal credit program managers to develop better documentation on their loan portfolios,

- measure and budget for the subsidies of credit programs,
and
- reduce the deficit in the years of portfolio sales.

To accomplish these objectives, the administration is proposing a market plan approach under which all new direct loans would be promptly sold. They would be sold without federal guarantees or other recourse provisions, and the purchasers would assume all of the responsibilities and costs of servicing the loans. Proponents believe that the requirement to sell the loans would give federal managers an incentive to assure that all new loans have documentation that meets commercial standards.

Furthermore, unlike in present practice, the budget would show the subsidy outlays involved in the new loans. The subsidy amounts reported would be the difference between the sale proceeds and the face value of the loans sold.

In the case of loan guarantee programs, the government would transfer the contingent liability of the guarantees to private insurers by purchasing insurance covering the potential liabilities. Any net costs to the government of this "reinsurance" would be scored in the budget as a subsidy outlay. This would exclude any portion of the reinsurance costs covered by premiums paid by program participants.

There would be a central budgetary mechanism for handling these transactions, a new "Credit Revolving Fund." The Fund would have permanent, indefinite authority to borrow funds to initially finance the "nonsubsidy" part of new direct loan disbursements. The nonsubsidy part would be the estimated market value of the loans--that is, the amount the government expects to get when it sells the loans to private investors. When the loan sales occur, the sales proceeds would be given to the Fund, and presumably used to liquidate the Fund's borrowings from the Treasury.

In addition, the agencies that originate loans would pay the Fund amounts for the estimated "subsidy" parts of their direct loans. The agencies would pay these subsidy amounts before the loans are disbursed, and the payments would come from appropriations received in advance by the agencies.

A similar approach would be followed for loan guarantees. Reinsurance costs not covered by program participants' premiums--the "subsidy"-- would be covered by payments to the Fund from the originating agencies' appropriations.

GAO VIEWS

Let me turn now, Mr. Chairman, to our views on the

administration's credit reform initiative. We think that there are some positive features, and some problem areas.

First, the positive features. We agree that there is a need to reduce the government's costs of managing credit activities, and believe that the market plan could accomplish that in some loan programs where our administrative efforts are not producing desired results. Some programs are not managed very efficiently. Our work on debt collection problems shows that billions are uncollected, and additional billions are written off annually. Furthermore, much of this problem stems from deficiencies in agencies' debt collection procedures. If the government can't do a better job in those cases, then perhaps we should let the private sector try its hand. Properly structured loan sales in such cases could be one way of doing this.

We also agree that documentation on the borrowers and loans needs to be improved in some cases. This includes the need for better accounting records. A program of loan asset sales, or purchasing reinsurance for guarantees, would provide an added incentive to develop and maintain sound records. Both the government and potential investors would need to know the quality of the portfolios before entering sales agreements.

We see problems, however, in the administration's proposed approach to measuring the subsidy part of credit programs.

Proposal Would Not Provide a
Measure of the Subsidy Cost

In the administration plan, the direct loan subsidy amount that would be reported and budgeted for would be the difference between the face amount of a direct loan and the amount the government receives in selling that loan on a nonrecourse basis. The idea according to material provided to us is to measure the subsidy "based on the benefit to the borrower." Presumably, the purchase price would approximate the loan amount that the borrower would have been able to get on the open market, and the difference between that and the higher face amount of the government loan would be the subsidy benefit conferred by the loan.

Unfortunately, this would not provide a measure of the actual cost to the government of making that loan. In all likelihood, the subsidy benefit so calculated would be larger than the actual subsidy cost to the government of making that loan.

We think that for budgeting purposes, the subsidy measure should reflect the cost to the government of credit activities, not the subsidy benefit provided to the borrowers. We have two reasons for favoring this approach. First, measuring subsidy costs to the government would be consistent with a primary function of the federal budget, which is to provide a statement

of the costs (in outlays) of governmental operations. If the budget measured something other than the costs to the Treasury of programmatic decisions, it would become a more confusing document. We agree that it is important to know what benefits are conferred by credit activities, but this should be done outside of the budget's totals.

The second reason for favoring the measurement of subsidy costs rather than subsidy benefits is that the former approach would correct a problem in current budget scorekeeping conventions. At this time, the budget treats direct loan and regular expenditure programs alike even though they are different in a key way: true direct loans entail some repayment of funds to the government. To better compare the costs of the two kinds of programs, it would be necessary to focus upon that part of the loan programs that represents the net cost to the government--in other words, the subsidy cost. Reporting subsidy costs would permit lawmakers to make valid comparisons between loan and regular expenditure programs.

As we have stated elsewhere¹ the best measure of the subsidy cost would essentially be the difference between the borrowing

1 Statement of Charles A. Bowsher, Comptroller General of the United States, before the Legislation and National Security Subcommittee, House Committee on Government Operations, September 26, 1986; and GAO comments on S. 2142 provided to the Chairman, Senate Committee on Governmental Affairs, December 8, 1986.

cost incurred by the government when it financed the loan, and the present value (at that time) of the borrower's future repayments. This would tie subsidy recognition to interest rates and the government's cost of money at the time it made the loan.

In contrast, the administration's focus on subsidy benefits in effect shifts the calculation to interest rates and the private investor's cost of money at the time of the loan sale. The private investor's cost of money would be built into the investor's computation of the present value of the borrower's future repayments. This would determine the price the investor is willing to pay.

Because the investor's cost of money would be higher at any time than the government's--the government is a better credit risk--the present value to the investor of a future repayments stream likely would be less than the present value of that same income stream to the government. This alone would make the loan worth less to the investor than to the government, and have the effect of depressing the purchase price.

In short, basing the subsidy calculation on the private investor's lower present value would likely result in a subsidy amount higher than the actual subsidy cost to the government. This would reflect the realities of the private market at the time of the sale, but would not reflect the subsidy cost to the

government when officials originally made the loan. Our approach would recognize the costs to the government when the loan was made. This, by the way, is the approach that was recommended in 1967 by the President's Commission on Budget Concepts.

Proposal May Not Adequately Protect
the Financial Interest of the Government

We also think that the plan may not adequately protect the financial interest of the government. I am referring to the plan provisions to sell the loans "promptly" and without recourse. Although we don't know exactly what is meant by "promptly" (one draft bill being considered would require sales within 90 days) a requirement to sell loan assets within a certain number of days, and without any federal guarantee, insurance, or similar agreement to cover all or part of any future losses to the purchaser, could work against the government's financial interests in several ways.

First, sales without recourse provisions could artificially depress proceeds. We have reported² that revenues to the government are likely to be greater if loans of a similar nature are packaged together and are sold with some form of credit

² Loan Asset Sales: OMB Policies Will Result in Program Objectives Not Being Fully Achieved (GAO/AFMD-86-78 and 79, September 25, 1986).

enhancement. This is particularly true when the loans are of a type not normally negotiated in the private sector, since the financial markets tend to underprice assets with which they are not familiar unless the creditworthiness of the assets is assured. Because of this, credit enhancements such as partial recourse provisions would likely result in greater sale proceeds than would be expected under nonrecourse provisions. These credit enhancements should be expressly provided for in the plan.

Related to this, we note that OMB has adopted a budget scorekeeping rule designed to discourage the Congress and agencies from undertaking loan sales with any recourse provisions. Specifically, OMB proposes to classify sale proceeds as deficit-reducing receipts only if the sales are made entirely without recourse to the government. Under the OMB plan, if a sale is made with any recourse to the government, no matter how limited, the entire sale proceeds are to be classified for budget purposes as borrowings rather than as receipts. This means that the proceeds would not count toward agency or congressional deficit reduction targets. It is easy to see how this would discourage sales with recourse provisions.

This OMB scorekeeping rule is also contrary to OMB's own scorekeeping policy in established loan guarantee programs. The policy does not require the guarantees to be counted as borrowings.

We believe that under a recourse loan sale, the portion of the sale proceeds that represents the estimated amount the government would have to pay under the recourse provision should be treated for budget purposes as borrowings. The balance of the sale proceeds should be treated as receipts. This approach is consistent with GAO's position on budget treatment for other federal loan guarantee programs, which is that a guarantee should be accounted for at its estimated cost to the government.

We further note that a rigid requirement for "prompt" sales could hurt the government. For example, it may be that adequate documentation and loan preparation is not possible for some portfolios in 90 days. If agencies are forced to sell loans before adequate documentation has been prepared, proceeds may be further reduced. Also, in a period of rising interest rates (and falling prices for loan notes and other securities), it may be in the best interest of the government to delay a sale until the market price for securities has risen, although we would caution against the government "speculating" on the future course of interest rates as a matter of policy. Furthermore, the bill's requirement that all new loans be sold would not leave the government the option of retaining in its loan portfolio high quality loans with good principal and interest returns to the government.

Finally, with regard to reducing the federal deficit, we

feel that the market plan could potentially have very different effects on short- and long-run budget deficits. The immediate effect of selling loans would be to accelerate cash collections and thereby reduce the deficit in the short run. However, if the proposal's requirements--that all new loans be sold promptly and without recourse--artificially depress sale proceeds, the immediate, positive effect on the deficit could be more than offset by a longer run increase in the deficit. Even after adjusting for the time value of money, the stream of repayments that the government forgoes by selling a loan could be worth more than the revenue derived from the sale of the loan. We are currently studying this issue on several specific portfolios for another committee, and expect to provide testimony on the subject in late March or early April.

A further observation, Mr. Chairman, on the deficit problem. Sales of loan assets should not be seen as a way to resolve our fundamental deficit problem. Portfolio sales of \$5 to \$10 billion a year will accelerate collections but not change the basic structural imbalance between governmental receipts and outlays. More fundamental changes are needed to really address a deficit that has been running at about \$200 billion a year.

Need to Avoid Unintended Effects on Borrowers

Care also should be taken before undertaking loan asset sales to ensure that borrowers would not be affected in any way counter to their lawful rights or the policy of the government. Without adequate guidelines and sale provisions, portfolio sales could have unintended consequences for borrowers. For example, the government may, as a matter of policy, adopt certain debt collection and refinancing policies for a certain class of borrowers. Sales of their loans to private lenders could subject the borrowers to different debt collection and refinancing policies.

Need for Financial Statements and Independent Audits

Finally, let me conclude by stressing that credit program reform should not occur in a financial management vacuum. The dollar amounts involved are in the billions, and great care should be taken to assure accountability for these assets, and to ensure the discipline and integrity of the financial amounts that are reported. A critical first step in this regard would be annual financial statements for any new credit revolving fund, providing useful information on the fund's yearly operating results, and assets and liabilities. But to assure the accuracy of the reported amounts, we also would want to see independent audits of those statements. Audited statements would alert the Congress to major financial problems, and provide a strong incentive to administering officials to manage well and fully disclose the results.

This concludes my prepared statement Mr. Chairman. I would be glad to answer any questions.

Chairman CHILES. Mr. Blum.

**STATEMENT OF JAMES L. BLUM, ASSISTANT DIRECTOR FOR
BUDGET ANALYSIS, CONGRESSIONAL BUDGET OFFICE**

Mr. BLUM. Thank you, Mr. Chairman. I am pleased to be here today to discuss the administration's credit reform proposals.

ADMINISTRATION'S PLAN NEEDS EXPANDING

CBO agrees with the Office of Management and Budget that there are serious shortcomings with the current budgetary treatment of Federal credit programs that need to be addressed. Furthermore, we believe the administration's proposal makes a great deal of sense—namely, to substitute the subsidy cost of credit programs for the cash flows now shown in the budget. A concern that we have with this proposal, however, is that it does not go far enough.

In particular the administration's plan deals only with future credit activities. It would not eliminate the distortions in the budget from selling or refinancing loans made in previous years. One way of preventing this abuse of the current cash-based accounting system, which I want to discuss briefly this afternoon is to reclassify federal credit disbursements, repayments, recoveries, and loan sales as a means of financing in the Federal budget.

Mr. Chairman, with your permission, I would like to skip over the next few pages in my prepared statement, which deal with the current treatment of credit programs in the budget and an alternative solution, and turn instead to the bottom of page 3 in the statement which describes, very briefly, what the administration's proposal is. Since Mr. Wright brushed over this fairly quickly, I would like to—for the committee's benefit—give a very brief description of what is involved.

THE ADMINISTRATION'S PROPOSAL

The administration's credit reform proposal represents, in our view, a major step toward improving the budgetary treatment of credit programs by highlighting subsidy costs. Credit subsidy costs of new credit activity would be reported in agency budget accounts, and the associated cash flows for new loans and guarantees would be included in the account of a new revolving fund in the Treasury. Agencies operating Federal credit programs would request annual appropriations equal to the amount of subsidy to be provided to borrowers during the fiscal year. As loans are originated and guarantee commitments issued, agencies would pay the estimated subsidy value of those credits to the central revolving fund from these appropriations. The central fund would then disburse loans and make guarantee claim payments, financing these outlays with subsidy payments from the agencies and with borrowing from the Treasury. This proposal is also the heart of Senator Heinz' bill, as I understand it.

CBO's principal concern with the Administration's proposal, as discussed at the top of page 5 of my prepared statement, is that it does not go far enough in protecting the budget from artificial cash flow distortions. In particular, the proceeds from sales and refi-

nancing of existing loans—those originated before credit reform—will still be scored as short-term deficit reductions under current budgetary practice. The reason the proceeds will result in deficit reduction is that they represent accelerated loan repayments that will be scored as offsetting collections. The budget deficit, which presumably measures changes in the Government's financial condition, should not be affected, however, by the receipt of repayments already expected or by induced prepayments of existing loans. As Martin Feldstein testified before this committee last week, asset sales are not deficit reduction. Further, as both Feldstein and Alan Greenspan noted, the sale of assets has essentially the same effect on credit markets as the sale of an equal amount of Government bonds. The administration's proposal for loan asset sales from the existing loan portfolio—as distinguished from credit reform, is projected to reduce the deficit more than \$5 billion in 1988.

The administration's plan also would permit short run deficit reductions to be achieved through the conversion of direct loans into guarantees, and through refinancing of existing loans with federally guaranteed private loans. If, for example, a direct loan were to be replaced by an equally subsidized loan guarantee, no subsidy cost savings would be achieved, but the cash-based deficit would be reduced by the switch in the form of credit assistance. Similarly, refinancings of existing loans with federally guaranteed private borrowing would still result in a short-run deficit reduction even though a new subsidy cost is charged.

THE MEANS OF FINANCING APPROACH

One way to immunize budget outlays and the deficit from the distorting effects of repayments, existing guarantee disbursements, asset sales, and switches from direct loans to guarantees would be to include the subsidy cost in the agency accounts, as the administration has proposed, and to reclassify all credit cash flows as a means of financing the deficit. Under current conventions, the deficit is considered to be financed by changes in Treasury cash balances, changes in checks outstanding, seigniorage on coins, and borrowing from the public. The means of financing portion of the budget could be defined to include all credit cash flows, on the grounds that repayments and loan asset sales (net of disbursements) are sources of cash financing for the budget.

The consequences of such an expansion of the means of financing a section of the budget deficit are illustrated in table 1 on page 7, of my prepared statement which use data from the President's proposed budget for 1988. For example, the first line of the table shows the cash-based deficit for 1985 of \$212.3 billion. Then, the estimated \$16.3 billion in subsidy cost of new credit extended in that year which is the objective of credit reform, is added in. Next, net loan disbursements of \$32.5 billion, which inappropriately increase budget outlays and the deficit, are subtracted. Similarly, loan sale receipts of \$1.5 billion are added to the deficit, because they have been used—inappropriately—to reduce, the cash-based deficit. In our view, the adjusted deficit of \$197.6 billion is a more meaningful measure of the changes in the financial condition of the Government.

Below the dotted line, the table shows how the adjusted deficit is financed. The cash deficit, which includes the net cash outflows, would be financed exactly as it is now—by changes in Treasury cash balances, checks outstanding, and borrowing from the public. Subsidy costs that have been recognized but not yet paid, and the receipts from loan asset sales, provide the residual means of financing for credit activity not financed by other means.

Mr. Chairman, precedents exist under cash-base accounting for the recognition of costs not yet paid and for the inclusion of these costs in the means of financing section of the budget. For example, at the present the accrual of interest payable on Treasury debt is included in Federal outlays and the deficit, and also as a means of financing. A further expansion of the financing portion of the budget therefore would not represent, in our view, a fundamental departure from existing budgetary concepts.

In summary, Mr. Chairman, by emphasizing subsidy costs rather than cash flows, the administration's proposal for credit reform should substantially improve the usefulness of the budget in depicting the cost of Federal credit assistance. Further, by reclassifying Federal cash flows as a means of financing the budget, rather than "above the line" outlays and receipts, the potential budgetary distortions from the pre-reform portfolio of loans and guarantees can be avoided. These advantages appear to be sufficient to warrant further consideration of this suggested accounting change.

Thank you, Mr. Chairman.

Chairman CHILES. Thank you very much, Mr. Blum.

[The prepared statement of Mr. Blum follows:]

Statement of
James L. Blum
Assistant Director
Congressional Budget Office

before the
Committee on the Budget
United States Senate

March 4, 1987

Mr. Chairman, I am pleased to have the opportunity today to discuss the Administration's credit reform proposals. CBO agrees with the Office of Management and Budget that there are serious shortcomings with the current budgetary treatment of federal credit programs that need to be addressed. Furthermore, we believe the Administration's proposal makes a great deal of sense--namely, to substitute the subsidy cost of credit programs for the cash flows now shown in the budget. A concern that we have with this proposal, however, is that it does not go far enough.

In particular, the Administration's plan deals only with future credit activities. It would not eliminate the distortions in the budget from selling or refinancing loans made in previous years. One way of preventing this abuse of the current cash-based accounting system, which I will discuss this afternoon, is to reclassify federal credit disbursements, repayments, recoveries, and loan sales as a means of financing in the federal budget.

SHORTCOMINGS OF CURRENT TREATMENT

As discussed in the 1987 Annual Report of the Congressional Budget Office (CBO) and in the CBO Analysis of the President's Budgetary Proposals for Fiscal Year 1988, the current budgetary treatment of federal credit activities gives a misleading picture of program costs and can distort the federal deficit. These difficulties arise because cash-based accounting, designed to capture the cost of spending programs, is ill-suited to credit activity, which necessarily involves the exchange of cash now for promises to pay cash in the future.

Under current, cash-based accounting, when a loan by the federal government is disbursed to a borrower, the full amount is scored as outlays just as if the loan were a grant. This treatment overstates true cost because it ignores the repayments that the federal government expects to receive in the future. On the other hand, repayments are scored as offsetting collections when received. As a consequence of the netting of disbursements and repayments, if repayments from old loans equal new disbursements, credit agencies may show net lending of zero in a year in which a large volume of deeply subsidized loans were originated.

Similarly, loan guarantees have no outlays until a default occurs. The substantial delay between commitment and outlays for guarantees results in an understatement of the costs of new guarantees in the year in which the government commits itself to this liability. Cash-basis treatment also requires that the current year budget accounts show current year guarantee fees as offsetting collections in the year received and current disbursements to honor old guarantees. This information is not useful to the Congress in assessing the cost of current guarantee activity.

A GENERAL SOLUTION

The current treatment of federal credit programs fails to produce useful information because current year cash flow is an inappropriate measure of new direct loan and guarantee cost. Cash flows are often incidental to and separated by time from the delivery of the subsidy. Instead, it would be more informative if the budget included a grant-equivalent measure of the

costs of all current period loan obligations and guarantee commitment entered into in that year. Subsidy cost--or the present value of future defaults, interest losses, capital costs, and administrative expense--is such a measure. Specifically, outlays would more closely approximate long-run costs and the deficit would not be distorted by incidental monetary flows associated with credit if current period outlays:

- o Included the subsidy cost of new direct loans and new guarantees but
- o Excluded new loan disbursements, repayments from old and new loans, receipts from the sale of old loans, and disbursements to meet guarantee commitments.

This observation is not new. The President's Commission on Budget Concepts recommended in 1967, for example, that only the subsidy elements in federal loans be included in the expenditure portion of the budget.

THE ADMINISTRATION'S PROPOSAL

The Administration's credit reform proposal represents a major step toward improving the budgetary treatment of credit programs by highlighting subsidy costs. Credit subsidy costs of new credit activity would be reported in the agency budget accounts, and the associated cash flows for new loans and guarantees would be included in the account of a new revolving fund in the Treasury. Agencies operating federal credit programs would request

annual appropriations equal to the amount of subsidy to be provided to borrowers during the fiscal year. As loans are originated and guarantee commitment issued, agencies would pay the estimated subsidy value of those credits to the central revolving fund from these appropriations. The central fund would disburse loans and make guarantee payments, financing these outlays with subsidy payments from the agencies and with borrowing from Treasury.

Subsidy cost is defined as the additional payments a borrower would have had to make for a fully private, rather than a government-assisted, loan. The size of the subsidy can be estimated either by sampling market interest rates and performing the calculations or, more directly, by making and then selling loans, and by reinsuring guarantees with private insurers. For loan sales and reinsurance, the subsidy cost is the government's loss on the transaction: for loans, the amount advanced less the sale price; for guarantees, the insurance fee paid to the insurer less the fee collected by government from the borrower.

The Administration proposes that subsidy cost estimates be obtained both by calculation and by sales and reinsurance. Loans that could be readily sold would be marketed to investors. Where private credit insurance is available, the government would reinsure its risk. For loans regarded as unsuitable for sale, such as those to foreign countries and for uninsurable guarantees, the central fund would calculate the subsidy and charge the agencies that amount.

A CBO CONCERN

CBO's principal concern about the Administration proposal is that it does not go far enough in protecting the budget from artificial cash-flow distortions. In particular, the proceeds from sales and refinancing of existing loans--those originated before credit reform--will still be scored as deficit reductions under current budgetary practice. The reason the proceeds will be offsetting collections is that they represent accelerated repayments that would have been so treated. The budget deficit, which presumably measures changes in the government's financial condition, should not be affected, however, by the receipt of repayments already expected or induced prepayments of existing loans. As Martin Feldstein testified before this committee last week, asset sales are not deficit reduction. Further, as both Feldstein and Alan Greenspan noted, the sale of assets has essentially the same effect on credit markets as the sale of an equal amount of government bonds. The Administration's proposal for loan asset sales from the existing loan portfolio--as distinguished from credit reform--is projected to reduce the deficit more than \$5 billion in 1988.

The Administration's plan also would permit deficit reductions to be achieved through the conversion of direct loans into guarantees and through refinancings of existing loans with federally guaranteed private loans. If, for example, a direct loan program were to be replaced by an equally subsidized loan guarantee, no subsidy cost saving would be achieved but the cash-based deficit would be reduced by the switch in the form of credit assistance. Similarly, refinancings of existing loans which resulted in

prepayment of the loans would be scored as deficit reduction under current policy and under credit reform.

THE MEANS OF FINANCING APPROACH

One way to immunize budget outlays and the deficit from the distorting effects of repayments, existing guarantee disbursements, asset sales, and switches from direct loans to guarantees would be to include subsidy cost in the agency accounts, as the Administration has proposed, and to reclassify all credit cash flows as a means of financing the deficit. Under current conventions, the deficit is considered to be financed by changes in Treasury balances, changes in checks outstanding, seigniorage on coins, and borrowing from the public. The means of financing portion of the budget could be defined to include all credit cash flows on the grounds that repayments and loan asset sales (net of disbursements) are sources of cash financing for the budget.

The consequences of such an expansion of the means of financing section for the budget deficit are illustrated in the attached table, which uses data from the President's proposed budget for 1988. For example, the first line of the table shows the cash-based deficit, \$212.3 billion in 1985. Then, it adds subsidy cost, which is the objective of credit reform. Next, net loan disbursements, which inappropriately increase budget outlays and the deficit, are subtracted. Similarly, loan sale receipts are added to the deficit because they have been used to reduce inappropriately the cash-based deficit. In our view, the adjusted deficit is a more meaningful measure of the changes in the financial condition of the government.

TABLE 1. EFFECT OF RECLASSIFYING CREDIT CASH FLOWS AS A MEANS OF FINANCING, 1985-1986 ACTUALS AND THE PRESIDENT'S PROJECTED AND PROPOSED BUDGETS, 1987-1988 (By fiscal year, in billions of dollars)

	1985	1986	1987	1988
Cash-based Deficit	212.3	220.7	173.2	107.8
Credit subsidy cost	16.3	16.9	15.0	12.7
Loan disbursements (including outlays for guarantees, net of repayments, recoveries, and fees)	-32.5	-15.2	-15.0	-10.6
Loan sale receipts (less reinsurance premiums paid)	1.5	1.6	6.0	6.6
Adjusted Deficit	197.6	224.0	179.2	116.5
Means of Financing				
Credit subsidy cost	16.3	16.9	15.0	12.7
Loan repayments (net of disbursements, guarantee outlays, recoveries, and fees)	-32.5	-15.2	-15.0	-10.6
Loan sale receipts (less reinsurance premiums paid)	1.5	1.6	6.0	6.6
Means of financing other than borrowing ^a /	15.0	-15.6	10.9	1.0
Borrowing from the Public	<u>197.3</u>	<u>236.3</u>	<u>162.3</u>	<u>106.8</u>
Total	197.6	224.0	179.2	116.5

SOURCE: Congressional Budget Office.

NOTE: Excludes Commodity Credit Corporation price support loans from credit; and also excludes subsidy cost for GNMA secondary guarantees. Details may not add to totals because of rounding.

- a. Includes changes in Treasury cash balances, checks outstanding, accrual of interest payable on Treasury debt, profit on sale of gold, and seigniorage on coins.

Below the dotted line, the table shows how the adjusted deficit is financed. The cash deficit, which includes the disbursements for credit, may be considered to be financed exactly as it is now--by changes in fund balances, checks outstanding, seigniorage, and borrowing from the public. Subsidy costs that have been recognized but not yet paid and the receipts from loan asset sales provide the residual means of financing for credit activity, not financed by other means.

Notice that borrowing from the public is not affected by this reclassification. That is a sensible result inasmuch as no real change in activity results from a mere accounting change.

The budgetary consequences of this reclassification are significant, however. The deficits for 1987 and 1988 using the President's budget figures increase by \$6.0 billion and \$8.7 billion, respectively. Adding in other CBO reestimates of the President's budget, the deficit for 1988 would be in the neighborhood of \$142 billion using this means of financing classification. If this accounting convention were adopted, therefore, some revision of the deficit targets in the Balanced Budget Act might be necessary.

Reclassifying the cash flows from federal credit assistance as a means of financing effectively protects the budget from distortion by disbursements, repayments, and loan asset sales. In addition, this change will assure that if loan asset sales are carried out, it will be for programmatic reasons rather than artificial "deficit reduction."

Notice that precedents exist under cash basis accounting for the recognition of costs not yet paid and for the inclusion of these costs in the means of financing section of the budget. Both OMB and CBO include the accrual of interest payable on Treasury debt in federal outlays and the deficit and as a means of financing. A further expansion of the financing portion of the budget would not represent a fundamental departure from existing concepts.

In summary, by emphasizing subsidy cost rather than cash flows, the Administration's proposal for credit reform should substantially improve the usefulness of the budget in depicting the cost of federal credit assistance. Further, by reclassifying federal credit cash flows as a means of financing the budget rather than "above the line" outlays and receipts, the potential budgetary distortions from the pre-reform portfolio of loans and guarantees can be avoided. These advantages appear to be sufficient to warrant further consideration of such a reclassification.

Chairman CHILES. Senator Sasser.

Senator SASSER. Mr. Chairman, I just want to say that the current budgetary treatment of Federal credit activities in my judgment needs to be changed.

It has long been acknowledged that cash-based accounting does not truly reflect the actual cost of Federal credit programs to the Government.

At a time of high budget deficits and fiscal restraint, we simply must develop a more effective way of looking at both the credit and debit sides of the Federal ledger.

I want to applaud you, Mr. Chairman, for calling these witnesses in here today, and I look forward to working with you in the upcoming budget deliberations on a more comprehensive evaluation of current credit practices.

Chairman CHILES. Senator Domenici.

Senator DOMENICI. Mr. Chairman, I, too, want to thank you for calling the hearing. As I understand it, with these hearings our hearing process is completed. Is that correct, Mr. Chairman, at least for the Washington-based ones?

Chairman CHILES. Yes, sir.

Senator DOMENICI. So that we have all of the hard work behind us.

Senator SASSER. That is right. Everything is easy now. We just put together the heaven and it will rise on its own.

CBO MEANS OF FINANCING PROPOSAL

Senator DOMENICI. Let me talk a little bit about your proposal. As I understand it, CBO's suggestion is that all cash flows associated with Federal credit programs should be treated as—I guess they are your words—a “means of financing” and not counted in the budget totals at all.

Is not this inconsistent with the principle that all Federal spending and revenues should be included in a unified budget?

Mr. BLUM. No; I do not think it is. It is consistent, for example, with the recommendation of the President's Commission on Budget Concepts in 1967, that the subsidy costs of credit programs be included in the expenditure portion of the budget. CBO is suggesting that the potential abuse by including the credit cash flows in the budget of loan asset sales, and other changes that give the appearance of deficit reduction, is so misleading and so potentially distorting that a change of this type is appropriate for consideration. This change would not hide these flows but merely reclassify the flows—which we think are more appropriately akin to borrowing in some instances—as a means of financing.

Senator DOMENICI. Perhaps the use of the term “unified budget” may be wrong, in the sense that it is a technical word, and it evolved over a long period of time. But my recollection of the short-term is that we were tremendously concerned about the Federal Financing Bank whose off-budget status—and you recall, that was not too long ago—was exploited. It was growing like topsy, nobody had any control over it.

So we put it all on budget. That just happened rather dramatically. You know, we just decided to put it on one day. You recall

that. You were working there. One year it was not; the next year it was, still is. You are saying take it off, along with some other things.

PLACE CREDIT SUBSIDY COSTS ON-BUDGET

Mr. BLUM. No; I would not characterize our suggestion as taking credit programs off-budget. What we would heartily endorse is the notion of having on-budget, for credit programs, the subsidy costs that are involved with these credit programs. We are suggesting that the incidental cash flows associated with these credit programs simply be reclassified elsewhere in the budget. I would not characterize this as being similar to—as you described—the abuse of the unified budget by having the Federal Financing Bank off-budget, where its activities were not being counted at all in the budget deficit.

Senator DOMENICI. Do you have any comments on that, either of the other two?

Mr. WRIGHT. Senator, I think that before we would go and start separating out categories of lending activities, we are into a much larger world than that.

I think the move that was made several years ago, that you talk about, to take the FFB, put it on-budget and establish it within either the unified or the cash-accounting budget was a good one.

When you think about pulling out parts of any lending activity, I think you are talking about moving away from the cash-accounting budget or the unified budget. I think you are getting into balance-sheet accounting to a certain extent, and it goes way beyond just this proposal on just credit, and so I think that should be very seriously looked upon.

I would not want to see us move away from what I thought was a good step several years ago, to take the FFB and put it on budget and count it within the cash budget.

Senator DOMENICI. Well, my time is up here, but let me just tell you that I think the current practices clearly obscure the costs of credit programs. Whether they are treated on-budget, or however, we are not very good at controlling them.

I would point out that we are now \$8 billion over the 1987 Resolution assumptions for direct loans, and if our staff is right, we are \$40 billion over for loan guarantees, and nobody seems to really think that makes much difference.

I mean, it is a nice accounting practice, and we know the numbers, but that is about where it is. Two further comments.

FHA USED TO SAVE BUDGET

What I would like to see is some reform that would minimize the magic we perform around here. I mean, when you have a budget resolution, and then you have got to meet targets in appropriations, we just have one new magic trick pulled out of the hat after another.

You will recall how we funded the supplemental appropriation the year before last, Mr. Wright?

Mr. WRIGHT. Yes, sir.

Senator DOMENICI. You remember. That was a neat trick, was it not? We had a real boom in housing, right? So we had to increase the limit for FHA financing \$58 billion, let them build some more. We collect the fee for each of those houses, up front, to cover future insurance losses. But here we use every penny of the insurance premium to pay for supplemental appropriation so it would not break the budget.

That was a pretty neat trick, was it not? Now the last trick we had is the REA co-ops, right?

Chairman CHILES. Yes; why not ask him if what he is proposing would change that score. That is the bottom line.

Senator DOMENICI. I do not think the one I just described, that your proposal would do that, would solve that, would it?

Mr. WRIGHT. No, sir. It would not.

Senator DOMENICI. Would yours?

Mr. BLUM. Yes.

Chairman CHILES. It would solve the REA—

Senator DOMENICI. I had not gotten to REA yet. I was now talking about that \$58 billion limit in the housing program. Would it cure that one?

Mr. BLUM. Yes, it would.

REA POSSIBLE BUDGET SAVER

Senator DOMENICI. How about the REA co-ops? Interest rates come down and now they all want to refinance. Nobody wants to be able to figure out what the 30-year costs are going to be, but the year we refinance we save a whole bunch of bucks so now we can spend it.

Mr. BLUM. If you recall that proposal also entailed allowing the rural electric cooperatives to refinance with private money but with a 100 percent Federal guarantee for that borrowing.

Senator DOMENICI. Right.

Mr. BLUM. Under the Administration's proposal, if that were a new guarantee, a subsidy cost would be recorded. But because of the cash-based accounting approach, the loan repayment—in essence, the refinancing—would still count as an offsetting collection and would be a big deficit reduction, and could finance your supplemental just as it did before. Under OBO's suggested changes in accounting, only the subsidy cost would appear. This approach would raise the deficit, not lower it, as occurs under cash-based accounting.

Senator DOMENICI. Thank you very much.

Mr. WRIGHT. Senator, let me change my previous statement. Credit reform would change the situation that occurred 2 years ago and I will tell you why. Because if you had charged the subsidy of the guarantee up front, like Jim just mentioned, it would not be a free good. Instead you would need an appropriation equivalent to the subsidy value.

Senator DOMENICI. Just so the record is correct, yes, it would, and it was not 2 years ago—I made a mistake—but I described the incident, so I think we are all talking about the same thing. It was 1 year ago.

Mr. WRIGHT. Yes.

Senator DOMENICI. Yes. OK.

Chairman CHILES. I think you are right on target.

Senator DOMENICI. The chairman says we are usually far more than 1 year off anyway around here. [Laughter.]

Chairman CHILES. Senator Exon.

Senator EXON. Mr. Chairman, thank you very much, and, once again, I think these have been a very informative set of hearings, and I thank you gentlemen for coming here to kind of wind things up for us today.

Do we have any figures on what is the total of loans that the Government has made in one form or another, that are presently deemed uncollectible? I am sure we have different categories of these things. I assume that there are loans that are in good shape, A number 1 loans, and grades down, B, C, D, E, and F.

I guess what I am trying to get at is, do we have a substantial amount of money that is eventually going to have to be charged off? I am sure there is some.

Do you have any idea of how much that is?

Mr. WRIGHT. Senator Exon, if I may answer your question in a slightly different way, and I will try to get to what you are asking.

Our total delinquent at the end of last year was \$68.2 billion. Forty-two billion dollars of that was taxes, and 26 point—

Senator EXON. Forty-two is taxes?

Mr. WRIGHT. Forty-two was tax debt. Yes, sir. Now a little over \$26 billion was non-tax debt. That was divided in the following ways: \$10 billion in agriculture; \$5 billion in education; \$2.1 billion in foreign debt; \$1.5 billion in Federal ship funding—MARAD, in other words—and all the other domestic non-tax debt was \$8 billion.

Senator EXON. That would be student loans in that last category and—

Mr. WRIGHT. No, sir. Education.

Senator EXON. Education, a separate issue?

Mr. WRIGHT. Education was separate. In the other domestic program area you would have everything from housing to the Small Business Administration to the Veterans' Administration.

Now the aging of the delinquent loans, in total, it looks like you have got around two-thirds to three-fourths that is over 1-year old.

Senator EXON. So, by banking accounting methods that would be considered charged off, lost?

Mr. WRIGHT. Exactly what—

Senator EXON. And what is that figure?

Mr. WRIGHT. Well, it looks like you have got around two-thirds to three-fourths of it that is over 1-year old.

Senator EXON. Of the \$26 billion?

Mr. WRIGHT. No, sir. Of the \$68.2 billion.

Senator EXON. Of the \$68 billion. OK.

Mr. WRIGHT. All right. Now I can give you a breakout, by the way, by category on aging.

Senator EXON. No, that is good enough.

Mr. WRIGHT. All right. Now what we had to do when I was with Citicorp is, when we went over 6 months we had to write off the loan.

The Federal Government just now is starting to get good aging and writeoff criteria. Believe it or not, we did not have it a couple of years ago at all, and that first year, when we started tracking delinquency, it went up 44 percent in 1 year. That is between 1981 and 1982. And all we had was two dots on the screen—we did not have any information before that.

So, from your own experience, you can draw your own conclusions as to how much you think is going to be written off.

Senator EXON. It is pretty staggering.

Mr. WRIGHT. Yes, sir.

DEBT WRITEOFFS DO NOT SHOW ON BUDGET

Senator EXON. Well, how does that show up on the budget? Does it?

Mr. WRIGHT. It does not show up on the budget, and this is one of the problems, because once you go and you write off a direct loan, there is no cost to that agency at all.

The cost to the agency on a direct loan is when the cash is disbursed or the direct loan is obligated on the front end. The only cost you have on a guarantee is when the guarantee comes back into the Federal Government again, and we actually have to pay off their guarantee agency at that stage.

When they write off that guarantee, there is no cost to the Government. Now that is just the wrong way to take it, because from a balance sheet standpoint, as you know, you are losing an asset, and the problem is you never record the change in the value of that asset in terms of a half of a trillion dollar, quote, unquote, Government-affected portfolio during the entire process.

Senator EXON. Have we done any kind of an adequate study, in your opinion, as to how much of these—if two-thirds of \$68 billion are in the category that you outlined, that is pretty surprising and shocking to me. I did not realize it would be that high.

Mr. WRIGHT. Well, I think, Senator, there is one part of that that is a very large increase, and that is the tax portion of it, and we are going to have to allow that to settle down just a little bit because that was complicated by two things.

First of all, they substantially increased their ability to track delinquent tax debt. Remember, much of it is not people who are trying to avoid the IRS. Much of it is errors that are made or incorrect deductions.

Senator EXON. In dispute, is that the way to put it?

Mr. WRIGHT. That is one way. They are able to identify it much better now. So the fact that they identify it suddenly increases the level.

The second part is much of the processing problems that they had last year has caused a lot of this delinquent debt from the IRS to pick up. We are going to have to give them at least another year to allow their automated collection process to settle down, to see how much of that will be written off.

Chairman CHILES. Do you want another minute?

FARM PROGRAM COSTS OVERSTATED

Senator EXON. Yes; one other question, gentlemen. I am interested in your analysis of the budget-accounting procedure which applied to Commodity Credit Corporation non-recourse loans.

It is my understanding that the CCC non-recourse loans are treated as direct outlays, and I think that has been pretty well established by the statement you just made, Mr. Wright.

As you know, farmers pledge commodities as securities for these loans, and they are commodities that they forfeit if the loans are not repaid.

It seems to me, that in the area of non-recourse loans, the Federal budget does not give credit for the commodities which secure these loans.

These commodities have some value, and the current system seems to overstate the actual costs of farm programs. What is the panel's view on this non-recourse loan, and is there validity to the concerns that I just expressed?

Mr. WRIGHT. Well, if I can just start very quickly, Senator, and then give it over to my co-patriots up here. Sorry, guys. They have a hard time——

Senator EXON. I was not trying to pick on you, Mr. Wright. If you have got somebody that can help ease my mind on this, I am delighted to hear from any and all of you.

Mr. WRIGHT. Well, Senator, we do not include the CCC in the credit reform proposals, and the reason we do not is because we look upon them as a purchase in commodities, all right, rather than a loan by——

Senator EXON. It is a purchase of a commodity?

CASH ACCOUNTING A PROBLEM

Mr. WRIGHT. Yes, sir. On the second part of your question, though, I will say that you are right. We pick up an asset, although it may not be at the value that we pay for it in terms of the open market, but we pick up an asset. Now you are getting into one of the problems of a cash accounting.

We do not reflect that balance sheet item as basically having any value unless we offset that thing through—for example—handing out the commodity in lieu of cash.

That in effect reduces an outlay. But this is a problem in terms of how we handle the budget accounting.

Senator EXON. That would be with the PIK program?

Mr. WRIGHT. Yes, sir, or the certificate program, either way. Once that certificate is cashed in for a commodity, that basically is an offset against a current services budget, if you assume that outlay would have occurred in the form of cash subsidy.

Now the difficulties that you have, though—and I want to make a point—is not only do we pick up the asset in the form of whatever that commodity is on our balance sheet, but remember, when we take over any type of a loan that is made, we also have an asset, and that is a loan to be repaid to the Federal Government that is not recorded anywhere, so there is not much difference.

Mr. WOLF. I would not disagree with that. One of the basic problems we are dealing with is these are not outlays, but rather, cash

transactions where we get an asset in exchange, whether it is for a commodity or for a loan-receivable.

As long as you do not deal with assets—which we do not right now—we are going to have some of these problems. That is why we tend to support change in the way we are looking at the budget for these.

Senator EXON. Gentlemen, thank you. Thank you, Mr. Chairman.

Chairman CHILES. Senator Nickles.

Senator NICKLES. Thank you, Mr. Chairman. I want to follow up on that same line.

COMMODITY LOANS SHOULD BE RECOURSE LOANS

In the case of CCC, you make a loan, particularly in the case of non-recourse loans, and a commodity is received in exchange for it. That commodity value is substantially less than what the loan value is, but you do not score any income going into the Government until and unless that commodity is sold for cash?

Mr. WOLF. That is right.

Senator NICKLES. So if it is given away, there is nothing, and/or if the Government holds that commodity for 3 or 4 years, then there is no offset made, either, is that correct?

Mr. WOLF. That is correct.

Senator NICKLES. I think we need some reforms in that area, to say the least. I will tell you that I have requested of the Secretary of Agriculture to look at this idea of trying to put some limitations on the cost of farm programs, and one of the suggestions that I thought should be reviewed would be to make loans above a certain level recourse loans.

So you would not necessarily be continuing to make all loans non-recourse loans, and therefore, continue to have the Federal Government paying in some cases almost twice what the market price is and receiving in exchange commodities that we already have.

Do you have any comments on that, or any other suggestions? I have heard the same thing that Senator Exon has heard—there is no credit given for these commodities; yes, we make the loan and receive the commodities but no credit is given. There is no scoring given, as I understand it now, unless that commodity is sold.

Is that correct?

Mr. WRIGHT. That is right, and normally, either the commodity is sold, or the commodity is given away in lieu of a deficiency payment or some other type, and that would be a reduction in the current services, that you are replacing a cash payment with a commodity payment.

Senator NICKLES. If you are replacing a cash payment—for instance—if a commodity was given to a food shelter, or something like that, and that commodity has a market value, do you credit that account for that market value?

Mr. WRIGHT. You would credit it up against the deficient amount that you were to be paid as an offset against the current services budget. So, against the plan—for example—we are on the Gramm-Rudman right now, in which we would be coming up against what-

ever the Gradison base line would be, that would be looked upon as a reduction in the deficit, but it is actually a cash disbursement replacement.

THE REA REFINANCING PROPOSAL

Senator NICKLES. OK. Let me move into something almost identical—and Senator Domenici brought it up as well—the REA refinancing proposal that Congress passed.

And incidentally, I am sure you are aware, there are additional and much greater proposals in the wings. Mr. Wright, did I understand your comment, that the repayment, even under your proposal would reduce the deficit? Let's say \$5 billion worth of REA loans were refinanced; would that \$5 billion be \$5 billion worth of income to the Treasury?

Mr. WRIGHT. What they would do is, they would come in, in the case you are talking about, and pay the direct loan. The direct loan would go up against the cash budget, reduce the deficit, and then, under our proposal, if you went out and guaranteed it again, the amount of the subsidy would be recorded as a cost, and that would be picked up by the agency who would have to come up and go through the appropriation process.

Now, the way we would do that under our proposal is the reinsurance package, and that subsidy, on a guarantee basis, would be the reinsurance premium that we would have to pay to the private sector to reinsure that guarantee.

Senator NICKLES. Mr. Blum, I was hearing you say that the administrative proposal does not go far enough. Am I correct?

Mr. BLUM. That is correct, Senator. Assume, for example, a \$5 billion refinancing of rural electric cooperative loans. The \$5 billion would be collected from them and recorded as an offsetting collection in the cash-based budget, and that would reduce the deficit by \$5 billion. Then a subsidy would be charged for the new Federal guarantee of private loans to replace that amount of money, and that subsidy could appear on the budget as an outlay, if it were reinsured in the private sector. But if it were not reinsured, it would have no effect on the budget. So what we would have, potentially, is a \$5 billion deficit reduction, whereas in fact the Government has incurred a new cost.

Senator NICKLES. Now if you purchase did the reinsurance—and that is in the administration's proposal—basically, you're talking about an outlay equal to whatever the cost would be to purchase private insurance.

Mr. BLUM. That is correct, and that cost would be much less than the \$5 billion.

Senator NICKLES. So it would be much less. So in effect you would be doing a refinancing package that would show on the books a substantial deficit reduction when you are still changing paper?

Mr. BLUM. That is right.

Senator DOMENICI. Would the Senator yield for one clarification.

Senator NICKLES. Go ahead. Sure.

Senator DOMENICI. Mr. Wright, in response to previous questions with reference to delinquent loans, you described in some detail

our failure to treat those the way the private sector treats them. You made a statement I think was in error—I do not think you intended it. You said if in fact we were to write off some of those, it would not affect the budget because the transaction had all been recorded at full dollar when the loan was made. But that is not totally true, is it, in that we still anticipate in the budget the repayment flow? To the extent that you write it off, you are getting rid of some repayment flow expectation which is substantial.

Mr. WRIGHT. First of all, yes, you are absolutely right.

Senator DOMENICI. I just wanted that in the record.

Mr. WRIGHT. Well, I would assume, though, Senator, before this would be written off, that the expectation of revenue flow by the agency would be very, very low.

But you are absolutely right, that they have been putting revenue flows in there, if you want to call it, as offsetting receipts, et cetera, et cetera, and you would lose that.

Senator DOMENICI. I mean, I am not saying it is appropriate to expect this flow. I am merely saying it is there. In fact it may be very erroneous. It may contribute even more so to the distortion because it may be very unrealistic.

Mr. WRIGHT. You are absolutely right.

BREAKDOWN OF TOTAL FEDERAL DEBT

Senator NICKLES. Mr. Chairman, just to finish my train of thought. Mr. Wright, both you and Senator Heinz mentioned the fact of a total Federal debt of in excess of a trillion dollars.

Looking at your statement, you said \$252 billion in direct loans, and \$450 billion in guaranteed loans. Where is the other—

Mr. WRIGHT. You have got Government-sponsored enterprises that had about \$453 billion in outstandings at the end of fiscal 1986.

Senator NICKLES. What do you mean by Government-sponsored enterprises?

Mr. WRIGHT. Fannie Mae, Freddie Mac, and Sally Mae. Many of those who say that they are private sector, but they jealously guard their holding onto the Treasury line of credit.

Senator NICKLES. And guarantees?

Mr. WRIGHT. Well, some have; some do not. Now, the difference very simply is the fact that they were able to go out there in the private sector and compete with at least a 50 basis point advantage on borrowing because of that Treasury contact, or Treasury line.

Senator NICKLES. Thank you, Mr. Chairman.

Chairman CHILES. Thank you, sir.

Mr. Wright, in your testimony, you seem to say that the President's credit reform proposals would not alter the underlying terms and conditions of credit programs. It would only change the way they are scored for budgetary purposes. May I ask you, first: do you think this will take legislation to make good on these proposals?

REA PLAYING UPON DESIRES OF DEFICIT REDUCERS

Mr. WRIGHT. Yes, sir, Mr. Chairman, I do. Pardon me. Senator Nickles, can I—I am sorry. I do not mean to interrupt. I really do not.

There is one more thing. We are talking about the REA co-ops. There is one thing that I really would like to bring up.

Remember, what they are doing right now is, they are coming in and saying we borrowed and signed a contract with the Federal Government at what we considered to be a fair rate.

Otherwise, they would not have borrowed. Now that the rate has gone down we want to abrogate that contract. You and I both know that if the rates were the same, or, certainly, if they were higher, they would not be in Washington, DC right now.

What they are doing is they are playing upon the—if you want to call it—the desire by the Congress and many in the administration to reduce the deficit through this prepayment mechanism.

But I just want to make the point, Mr. Chairman, that they are abrogating a contract that they had with the Federal Government.

FOREIGN COUNTRIES ALLOWED TO REFINANCE

Chairman CHILES. Mr. Wright, at the same time, this same Government is talking about unilaterally abrogating contracts with South Korea, with Egypt, with other countries that borrowed on concessionary loans with us to buy weapons. We decided to allow them to refinance those contracts at a hell of a lot lower interest rate. That was our initiative.

What the heck is the difference?

Mr. WRIGHT. I think there is a difference, Mr. Chairman, in the fact that on the countries that you're talking about—and we're very rapidly getting into where I am not an international expert—the countries that you're talking about, you can look upon that almost as if this is a grant, where you are providing in terms of international aid.

Chairman CHILES. Are we making that kind of grant to South Korea, a country that enjoys a tremendously favorable trade balance with us, that's beating our brains out and won't allow our goods into their markets? Are we just going to set that up and give them this money back?

Mr. WRIGHT. No; I understand what you're saying. I'm not saying that—

Chairman CHILES. I'm just saying let's treat the REA the same way we treat our foreign allies. They are good allies. I think the REA people are pretty good allies too.

Mr. WRIGHT. Well, also understand, too, that I think I was reading where the REA Administrator came in—and we're getting a little bit off the subject—but where he came in and basically stated that the REA co-ops right now are in one of the healthiest conditions they've been in a long time.

Chairman CHILES. I think they are, too. I don't like the idea that they have the inducement to allow us to incur more spending. But I think it makes sense, when every borrower I know of in the private sector, including myself, is trying to take advantage of lower interest rates and renegotiate loans and borrow at a lower interest rate, I have a hard time seeing why we're going to say that we shouldn't allow some other people to do it.

But your argument, you know, loses all of its validity to me, to say that we've got a contract and we're going to hold these people

to that contract, and when you're not going to hold the South Koreans and you're not going to hold those people to a contract.

Do you want to stop him further, or do you want to——

Mr. WRIGHT. No. I'll tell you something. I would be willing to go on, but I think you and I could probably go through the rest of the afternoon.

NOT ALL REC'S ARE IN GOOD SHAPE

Senator NICKLES. Mr. Chairman, let me just add in, because I know that Senator Exon and a number of us have worked on this question. I have tried to figure it out because I'm interested in helping the REC's in our State. I know the Administrator said they're in pretty good shape nationally, but we have a couple that are in very, very bad shape. I don't want them to default. Some of them have an average cost of capital in the 12-percent range and they might be able to get by if they could refinance.

A lot of us have done private refinancing and we would like to see if the REC's could find some private refinancing as well. Granted, they're not interested unless they have a guarantee. So again you get back into the question of the refinancing. I think there is some merit to the proposal. Yes, you come up with a few bogus dollars for deficit reduction if you want to accept the prepayment, but if you're requiring some type of payment for the subsidy for that new loan, for the guarantee amount, maybe that would offset it.

Chairman CHILES. Well, I personally think we ought to take away the right to have that so-called bogus repayment, allow you to have other spending as we see the financing of the supplements. I think that's where the problem is. I think you could then look on the merits and determine whether they should refinance.

What I want to ask you——

Mr. WRIGHT. Mr. Chairman, I'm sorry. I forgot what your question was.

Chairman CHILES. I asked you first whether it was going to take legislation, and you said yes.

Mr. WRIGHT. Yes.

PRIVATE REINSURANCE FOR FHA

Chairman CHILES. Under the current law, FHA insurance is federally guaranteed. Therefore, even if we were to purchase private reinsurance for the FHA commitments, the Federal Government is still going to have to honor any default immediately. Then you're going to have to try to settle with your reinsurance.

Given that, and the fact that your private reinsurance people here could go bust, does it make any sense that the Federal Government is going to have to go out and insure something like FHA? We're not going to get any better rate because we reinsure that in FHA. It just doesn't make much sense to me, that you're going to go out and pay the fees to reinsure that.

Mr. WRIGHT. I would like to think about that one, Mr. Chairman.

Chairman CHILES. All right.

Mr. WRIGHT. I'll get back to you on that.

Chairman CHILES. Fine.

[The following was subsequently supplied for the record by Mr. Wright:]

Any claims on the reinsured FHA guarantees would be paid by the reinsurer; HUD would have no further involvement with these loans. However, reinsurance entails a risk that the insuring companies could fail. The risk of loss of the Federal government due to the failure of the reinsurance company can be minimized through an annual payment of reinsurance premiums and careful selection of private mortgage insurers. However, since the loan guarantees are backed by the "full faith and credit of the U.S. Government," if the mortgage insurer failed, the government would have to honor any defaults from the loans of the failed reinsurer that occurred before another insurer was obtained. At most this would amount to one year's premium placed with that insurer.

Reinsuring loan guarantees is an important part of the credit reform proposal because it will provide an unbiased market test of the level of subsidies for loan guarantees like those made by FHA. Clearly, it will cost more to reinsure privately than what FHA currently charges. This is because these firms must pay Federal, State and local taxes and must maintain reserves (or obtain third party reinsurance) that enables them to withstand very stressful economic conditions. In contrast, FHA relies on its ability to borrow from the Treasury in the event of a catastrophic economic downturn. Thus, taxpayers ultimately bear the risk and cost associated with the limited reserves held by FHA. Accordingly, although there is a cost associated with reinsuring loan guarantees, it is more appropriate to budget for those costs up front and pay the private sector to bear the risk than to have taxpayers foot the bill somewhere down the road.

BAILOUT OF FSLIC NOT WITH TAX DOLLARS

Chairman CHILES. The Treasury has proposed the creation of a financing corporation to help bail out the Federal Savings and Loan Insurance Corporation. That new funding entity is going to provide FSLIC with billions of dollars to try to help bail out the failed savings and loan institutions.

My understanding is that the fees for that are going to come from existing savings and loans, the ones that are healthy right now; is that correct?

Mr. WRIGHT. That's right.

Chairman CHILES. Right now this isn't tax dollars that are going into this; this is an increased fee?

Mr. WRIGHT. Yes; these are earmarked funds that are coming in—

Chairman CHILES. Earmarked funds. But we ought to make clear when we say this that right now this is not a tax dollar bail out, that we're going to levy a higher premium on the existing institutions?

Mr. WRIGHT. Yes; in the credit reform package that we have, we don't see these earmarked funds coming into the fund—for example, we do not see either FDIC or FSLIC or any of the rest of those banking agencies receipts coming into the central fund that we're proposing. We do see them scoring the subsidy amount, so you can compare it to the other types of subsidies, and then on the guarantees, if they had gone to the guarantees, they would pick up the guarantee fee and score that.

HOW CREDIT PROPOSAL SCORES SUBSIDY COSTS

Chairman CHILES. OK. So, in keeping with your attempts to more accurately reveal the true long-term loan, how does that credit reform proposal score subsidy cost to the Government of the recapitalization financing corporation?

Mr. WRIGHT. I would say the only thing our proposal does, it just goes and scores the subsidy values of FSLIC loans to FSLIC. As part of the credit reform, it does not come into the central fund, as I mentioned earlier, and if they would make a guarantee, the guarantee subsidy would be scored.

Mr. WOLF. However, the way recapitalization is proposed right now, there is no guarantee of those borrowings. Therefore, there is no guarantee subsidy that we're talking about.

Mr. WRIGHT. On the FSLIC recap is what he's talking about.

Mr. WOLF. Yes.

Chairman CHILES. So it is no guarantee?

Mr. WRIGHT. On the FSLIC recap——

Mr. WOLF. On FSLIC recapitalization, the funding corporation's borrowings are not guaranteed by the Federal Government.

GOVERNMENT INVOLVEMENT IN BAILOUT COULD COST TAXPAYERS

Chairman CHILES. Mr. Blum, would you feel that the credit reform proposal adequately reflects the Government's involvement with the financing corporation? Is this going to be one of these things where eventually the Government has to ante up and put the money in, and we know we'll have to do that if we're required to?

Mr. BLUM. That situation could occur if the cost of solving the financial problems of the S&Ls turns out to be as high as some have estimated.

In terms of the budgetary treatment of the proposal to recapitalize FSLIC, this is something that we looked at long and hard last year when the administration initially proposed it. We had some problems with the initial proposal because it simply was another case of taking advantage of the cash basis of accounting, to have an apparent deficit-neutral transaction here. But the way the final proposal was formulated, under our current budgetary concepts we had to agree that given its structure, it would be deficit-neutral.

That proposal sets up a financing corporation that is part of the Federal Home Loan Banks, which are Government-sponsored enterprises and are off-budget. The borrowing that is clearly Government induced here—that is, the money borrowed for the purposes of closing down insolvent S&Ls—would go to the financing corporation and then, in turn, be "invested" in FSLIC. FSLIC could then use the money to pay off the insurance with those insolvent banks.

I think this is an example of the distortion that occurs and must be accepted, given the present accounting principles.

Chairman CHILES. Senator Danforth.

EXPLANATION OF IRS DELINQUENCIES

Senator DANFORTH. Mr. Wright, when you were going down the list in order of size in describing this situation, the Internal Revenue Service came first on the list; is that right.

Mr. WRIGHT. Total size——

Senator DANFORTH. Yes.

Mr. WRIGHT. Of delinquent debt?

Senator DANFORTH. Yes.

Mr. WRIGHT. Yes, sir.

Senator DANFORTH. What is that? I know that Senator Exon asked you about it. What is a description of this situation? Are these "deadbeats" or are these bankrupt people? Is this a matter in litigation?

Mr. WRIGHT. I can give you a better breakdown of exactly what that is. I don't have that with me right now.

[The following was subsequently supplied for the record by Mr. Wright:]

A description of the delinquent debt held by the IRS is as follows:

[In millions of dollars]

Source of Delinquent Debt	September 1981	September 1985
Notice	5,739	13,661
Taxpayer delinquent accounts	4,679	11,922
Installment agreements	569	777
Not collectible	3,935	8,995
Deferred	199	392
Other system monitored	2,652	6,152
Total delinquent	17,773	41,899
Total not delinquent	595	5,746
Grand total	18,368	47,645

DEFINITIONS OF ACCOUNTS RECEIVABLE CATEGORIES

Notices.—This category includes unpaid tax accounts for which a notice has been issued by one of our ten service centers and which are more than 30 days past the latest assessment date. This is the first step in the collection of delinquent taxes. Taxpayers receive up to five notices from the service centers. Routine notice cases remain in notice status for either 13 weeks (BMF) or 25 weeks (IMF) before a Taxpayer Delinquent Account (TDA, see below) is issued. Accounts can remain in notice status longer than the normal period if we suspend the notice process while we research the taxpayer's account (e.g., to locate a missing payment). The notice process can also be accelerated in cases where the amount of the liability or the taxpayer's previous history indicates that personal contact should be initiated sooner.

Taxpayer delinquent accounts (TDA).—TDAs are those accounts which have been issued to Collection's Automated Collection System (ACS) for telephone contact or to the Collection Field function (CF) for personal contact. These are accounts that have completed notice processing. TDA status includes those accounts assigned to the queue under the Workload Priority and Selection System. The age of accounts in TDA inventory is shown on the attached chart.

Installment agreements (IA).—Installment agreements are issued to those taxpayers who meet Service criteria to pay their delinquent account in regular installments. Accounts remain in this status until the account is paid or the taxpayer fails to keep the terms of the agreement.

Currently not collectible (CNC).—Accounts which the Service has determined to be currently not collectible due to hardship, inability to locate the taxpayer or because a corporate taxpayer is defunct without assets are removed from active inventory. Like all delinquent accounts, CNC accounts are monitored for refunds due which are normally offset against the outstanding liability. They are also monitored for changes in the taxpayer's condition such as an increase in income or a new address which may cause the account to be reactivated to TDA status.

Deferred.—Active collection of accounts whose aggregate balance falls below the established cost-effectiveness level is deferred until the aggregate balance exceeds the criteria. These accounts are monitored for future refunds which are offset to the delinquent account.

Other system monitored.—Accounts on which collection is suspended are monitored on our computer system. This line includes accounts not included in the categories above, primarily accounts in litigation (e.g., bankruptcy or tax court) or an adjustment pending to a TDA that will satisfy the liability.

Nondelinquent.—Accounts for which the taxpayer has elected a statutory installment privilege (Estate and Highway Use taxes) and, since September 1985, accounts in notice status that are less than 30 days old are reported here.

Mr. WRIGHT. We have asked the IRS to explain why the delinquencies have gone up so dramatically. They grew from about \$18 billion—this is delinquent tax debt now—in 1981, to about \$42 billion in 1986. They're holding at about 60 percent of all delinquent debt for the Government. I believe that it's a combination of, number one, of them being able to better identify tax delinquencies, and number two, as a result of the processing problems they have had in the past several years, that now has settled down.

What they have said is a preliminary analysis reveals the following: first, taxpayers sometimes omit or incorrectly enter information on their Federal tax deposit coupons causing payments to be applied improperly to accounts other than the correct ones. The taxpayers are then considered delinquent on taxes already paid and some errors are made.

Senator DANFORTH. In other words, the \$42 billion may be overstated?

Mr. WRIGHT. Well, it may be. Here's where I say I want to be careful on this a little bit. I think there is an understatement that occurs because of many of the processes that we followed in the past which don't pick up all of the omissions. That's why I say we've got to let it settle down for a year or two, to be able to find out exactly what is going to be the results of the improved automated process for collection that they've put in.

WHAT IS BEING DONE

Senator DANFORTH. Does the administration have any proposals. The last time we tried to tackle this problem, as I recall, it was the great withholding on interest and dividends flap. I mean, what do you suggest for a \$42 billion delinquency? Is anything cooking? Are you making any proposals to Congress? Is anything going on within the IRS to address this situation?

Mr. WRIGHT. OK. You know one thing, Senator, that there has been a substantial investment of about \$50-\$75 million—I'm guessing—in new automation within the Internal Revenue Service. What we're talking about here is a collection problem. I don't think it's an underwithholding or overwithholding or necessarily reporting. I think it's a collection problem.

The collections against those delinquencies was \$19.6 billion in 1986. The IRS has told us that they plan to collect \$21 billion against those this year, and \$23 billion against those next year, fiscal 1988. We'll see if they do.

Senator DANFORTH. You think it's basically then just a matter of better equipment and—

Mr. WRIGHT. Sure. That's going to help out with the work load they've got. And I think they've got a very good management system. However with the new tax laws, I think every improvement made will be appreciated. But again, at this stage, I'm just looking at the analysis as it's first coming in, and there has been an alarming rise in the delinquencies of tax debt at the Internal Revenue Service.

Senator DANFORTH. Thank you, Mr. Wright.

Senator LAUTENBERG [presiding]. Thank you very much.

Senator SIMON.

Senator SIMON. I would like to follow through on Senator Danforth's last question, concerning the amount you're talking about the IRS collect.

Mr. WRIGHT. I'm sorry.

Senator SIMON. That amount that you're talking about the IRS collecting, is that included in the revenue assumptions within this budget?

Mr. WRIGHT. Yes, sir, it is.

FEDERAL CREDIT PROGRAMS NOT COSTLESS

Senator SIMON. In going through your statement, Mr. Wright, I note that you say "the fact that loans are expected to be repaid leaves the impression that, over time, they are costless. But this is not so because Federal credit programs provide subsidies to borrowers."

Now, are you talking about direct subsidies, or what are you talking about when you say they are not costless here.

Mr. WRIGHT. OK. A direct loan can either have a straight interest rate subsidy, which is the easiest; it can have a term subsidy, when they have a longer of time to pay it back; it can have a grace period subsidy—for example, like in the guaranteed student loan program where you don't have to even start your payments until 6 months after you graduate it can have a renegotiation of a contract subsidy, which a bank would not allow—in other words, if you can't make the payment, going ahead and reducing it; or it can have the maximum subsidy, and that is the case where I believe the Congress, in the last year, put a prohibition against using private sector collection agencies to collect Farmers Home debt. That's \$7.5 billion now that is in delinquent debt that may not be collected at all. That is the ultimate subsidy.

Because, in effect, you have a debtor—for whatever the good reasons may be—who is able to walk away, and you are prohibited from using good collection techniques. So I would say in all of those, you start from the simplest one, interest rates, then you go through terms and all the rest.

REA SUBSIDY

Senator SIMON. For example, REA was being talked about when I came in here.

Mr. WRIGHT. Yes, sir.

Senator SIMON. In fact, there is no cost to the Federal Government in the REA; is that correct, or am I not correct.

Mr. WRIGHT. The REA, the interest rates vary all over the place, depending upon when the loan was originally made.

Senator SIMON. Assuming a loan was made, say, in the last 2 or 3 years, they pay, in fact, above the cost to the Federal Government?

Mr. WRIGHT. I understand, yes, they are subsidized from the interest rate, and then also from a risk standpoint. From the risk standpoint because we're providing guarantees that the private sector normally would not provide.

Now, in the budget, we come up with, every year, an estimate of the subsidies. The estimates will range all over the place, from a very, very low amount—let's say like less than 2 or 3 percent—all the way up to 95, 96 percent. In many cases, the way we establish that is not only through the interest rate charged but what would the private sector charge to provide that type of guarantee on the credit risk. That can be one of the biggest parts of the entire subsidy. That, I believe, would be the largest part on some of the REA co-ops.

Senator SIMON. In that case, in fact, the Federal Government is unlikely to make any expenditure. You do have some stimulation to the economy out there. I guess you could argue that the net cost to the Federal Government is probably zero.

Mr. WRIGHT. Well, except for one thing, Mr. Simon. That is, if the Federal Government decides that what we are going to do is place credit within that sector, for whatever good reasons there may be, at least we ought to know what the costs are, so that we can compare it to what we're providing them elsewhere and also compare it, for example, to grants or direct spending programs.

Senator SIMON. I agree on that.

Thank you, Mr. Chairman.

EFFECTS OF FSLIC RECAPITALIZATION

Senator LAUTENBERG. Thank you very much, Senator Simon.

If you don't mind, I would like to just step back to the FSLIC question. It has been asserted that if we recapitalize FSLIC, as proposed, that, in fact, it would have a peculiar accounting effect, even though realistically it might not do anything toward real budget deficit reduction. I think Mr. Blum was talking about it.

Could you just go through the effects of a recapitalization for FSLIC?

Mr. BLUM. Certainly, Senator. The administration's proposal is to create a financing corporation that would be a subsidiary of the home loan banks, which are off-budget as Government-sponsored enterprises. These banks are privately owned and, under present budgetary concepts, are treated as not being part of the budget.

The financing corporation would borrow money from the private sector and, in turn, use those borrowings to invest, in effect, in FSLIC on-budget. Those investments would be scored as an offsetting collection, or a negative outlay. In turn, FSLIC would use those receipts to make expenditures to bail out—to buy out, in effect—the insolvent S&Ls. Those outlays then would be positive. Thus, the borrowing, which is invested in FSLIC, comes in as a negative outlay. The payments by FSLIC to close down the insolvent S&Ls would be positive outlays and the net effect would be close to deficit-neutral during the year.

In contrast, suppose FSLIC borrowed from the Treasury to get its funds for making these expenditures. In that case, only FSLIC's expenditures would be on the budget, but that would represent only the outlays and lead to an increase in the deficit.

Senator LAUTENBERG. So under the present proposal it's a net wash; in effect, it is a reduction because we avoid laying out the funds otherwise. But it doesn't in any way reduce the deficit on a

direct basis. We would have a further increase in the deficit if we went ahead and financed this out of borrowings from the Treasury.

Mr. BLUM. Yes; but this is, in fact, Government-induced borrowing. From the point of view of the credit markets, there is really no difference in terms of the impact that the Federal Government is having on them by causing this borrowing to be made.

It turns out that we're simply taking advantage of scoring conventions to not show this on the budget.

Mr. WOLF. Senator, if I can add a comment, as a practical matter, in the first couple of years there probably will be a plus—a reduction in the deficit—because we're going to take more in than FSLIC will be spending in those first couple of years, maybe as much as a billion or two. Just in terms of timing.

Senator LAUTENBERG. That is off the budget, but is that counted in terms of—

Mr. WOLF. The way the mechanics of the process work, considering the timing and the way that FSLIC will pay out the money, you will probably see in the first year, and probably even in the second year, more funds actually coming in and reducing the deficit than go out by FSLIC to pay off the S&Ls, just because they can't process them that fast.

Senator LAUTENBERG. There is certainly a question about whether, in fact, there is a real effect on that.

DEFICIT EFFECT OF PRESIDENT'S CREDIT REFORM

I wanted to ask a question about the administration's credit reform proposal. If we did that for fiscal year 1988, is there a projection on how that would affect the deficit number?

Mr. WRIGHT. Yes, sir. In fiscal 1988, under the proposal we come up with, it would be \$11 billion that would be subject to the credit reform proposal. If we would sell \$4 billion of that, and we would reinsure \$8 billion worth of guarantees for half-a-billion dollars, the deficit would be reduced in fiscal 1988 by \$1.3 billion, in fiscal 1989 by \$600 million. Then it would be a net cost in 1990 of \$900 million, in 1991 of \$2.2 billion, in 1992 of \$3.6 billion, and the reason is because we've got a 5-year phase in on the reinsurance of the guarantees.

Senator LAUTENBERG. So the long-range effect is a net increase in the deficit, though it feels good in the first year or two?

Mr. WRIGHT. It's a net increase in the deficit, but then again, in that 1991 and 1992, we do not have any offsets that are recorded against the savings we would make by not having to pick up guaranteed loans that would have defaulted and come back in as a cost to the Federal Government. We don't have enough information to be able to put that in. But those would start phasing in somewhere in 1991-1992.

Let me give you an example on some of the SBA business guarantees. You would start seeing some of those, which normally would have come in and hit our responsibility in 1991 or 1992 that would not under the reinsurance program. But the way we have it recorded, yes, it's a net increase in the deficit starting in 1990.

BEST CREDIT PROGRAM ACCOUNTING

Senator LAUTENBERG. As you all know, part of the concern about what we're doing short range is that it makes us feel good right now but, in fact, it doesn't really—in my view, anyway—add a structure that guarantees the continuation of these steps in terms of the deficit reduction mission.

Part of the reason that we need to reform credit program accounting, is to have better understanding about the best way to fulfill a given policy.

What do you think is the most cost-effective way of doing that? Is it direct loans, is it guaranteed loans, grants-in-aid, tax deduction credits. Do any of you have a view on that.

Mr. WRIGHT. Mr. Lautenberg, my feeling is that totally depends upon which category you're talking about. I personally believe that the private sector is willing to pick up more of the financing for many more of these groups than we're willing to admit. I think sometimes we want to hand out the loans, or we want to make the guarantees, more as a matter of "Federal control" than we do in terms of really letting the private system work.

Now, that's not in all cases. I think we have overplayed the hand on Federal control within the credit areas to the point to where, if we really took a look at the transfer in credit that has gone from many of our productive areas to many of our nonproductive areas, I think we would probably question whether or not there's great wisdom there. But I couldn't answer that simply between guarantees and direct and tax breaks and all the rest of it. I think it depends upon the situation.

Senator LAUTENBERG. If the marketplace takes over, however, you say the private sector could become more engaged—and we think they might—we would be looking at a substantially different cost to the beneficiary, the borrower, than we presently have; wouldn't you think so?

Mr. WRIGHT. Yes, sir, I think you might be doing that. But I think also what you might be doing, you might end up looking at a healthier business that didn't have to depend on Federal subsidies.

Now, again, there are exceptions to that. I don't mean to say that's true in all instances. But I just think that we've gone too far.

MUST UNDERSTAND CREDIT SUBSIDIES

Senator LAUTENBERG. The question is whether we're operating a business or trying to make programs effective in meeting national needs, the national interest, and there is debate about that.

I would like to see the accounting cleaned up. I come out of a computer business and I'm very familiar with accounting procedures. I'm still baffled by the systems used by Government, whether it's capital or operating budgets. But, nevertheless, we have to decide on how valuable these programs are and whether or not we really want them. What I want to make sure of is we understand fully the subsidies involved. Right now it's not clear at all.

Mr. WRIGHT. If I may make two comments on that, because I do know of your interest in this area—and welcome it, by the way; I think it's badly needed in this town.

I think, first of all, you might be delighted to see that when the management report comes up later this month as part of the fiscal 1988 budget—it will be our third one—it will reflect our efforts—as a matter of fact, we've been working very closely with GAO and Treasury and the other agencies to put in a Government-wide financial accounting system by the end of calendar 1988. I think, even if you take a look at it with your critical eye, you will think it will be an effort worthwhile.

Senator LAUTENBERG. It sounds exciting.

Mr. WRIGHT. It is. It's a good one, it really is, and it's past where it should have been 10 or 20 years ago.

The second one is, within the credit proposal, one thing that is overlooked is the management of the credit itself. As the loan asset sales are going on right now, people are focusing on deficit reduction and they're missing the fact that agencies at the present time are upgrading the information on their portfolios, which we would need for credit reform in any case, to be able to establish subsidies. They have not had this information before.

The only reason they're doing it is because they've got outside, private financial advisors who are in there with them right now and they're getting their portfolios ready for sale. It would not have occurred otherwise.

The second part is, you know, we can combine the best aspects of the Federal Government policymaking, like what you're talking about, with the subsidies to make better decisions, with the best aspects of the private sector, which is basically the management of the loan and the collection, once it's made. That's an important part that's often overlooked in this proposal.

WOULD PRIVATE CREDIT BE BETTER

Senator LAUTENBERG. Is there a cost additional to the interest rate differentials, the subsidized rate, based on lack of good collection processes, administration, management and so forth? There is a significant hidden subsidy that we don't identify. Do you think we would reduce that substantially if the private sector just managed some of these loans. Do you think that's a practical goal?

Mr. WRIGHT. Yes, sir, I think it is.

Senator LAUTENBERG. Well, I don't know whether the phone calls at night—saying "Listen, you have until next week; otherwise, we'll take away your dog"—whether that places the Government in a more oppressive light than most people traditionally see it. It's antisocial behavior in a way.

Mr. WRIGHT. Well, as you know, you can pretty well establish whatever conditions you want with the collection agency, under what conditions they call, when, what the dunning sequence is going to be, what the letters say and everything else.

The point is that Federal agencies traditionally are not used to working with the private sector this way, and we are only in our second year of transferring accounts out to the private sector. There's no question about it, that there were some mistakes made. There always are when you start something.

Now, as we gain more experience, though, I think it is unquestionable that the private sector is better at managing collections

than the Federal agencies are. Federal agencies are geared towards handing out money. They don't look upon the fact that, you know, they have to collect it back in. As a matter of fact, I can't recall a single hearing that there's ever been, where a Senate committee has brought in an agency and said, "You're doing a bad job in the collection of your debt." I can recall quite a few that have said, "You're not handing out enough money."

Senator LAUTENBERG. Well, that could get to be a philosophical discussion, which we don't have time for.

Mr. WRIGHT. Yes, sir.

Senator LAUTENBERG. It's very provocative and, unfortunately perhaps a more accurate statement than lots of what we hear in hearings.

We have several questions that we will submit to each of you, or one of you, and I would ask that you respond to that. Otherwise, this hearing is adjourned, and we thank you for your testimony. We'll call you back if we need you.

Mr. WRIGHT. Thank you, sir.

[Whereupon, the committee adjourned at 3:47 p.m.]

[The following material was submitted for the record:]

STATEMENT OF SENATOR PAUL TRIBLE, OF VIRGINIA, SUPPORTING
THE FEDERAL CREDIT REFORM ACT OF 1987

Mr. Chairman, Members of the Budget Committee:

I welcome the upcoming introduction of the Administration's "Federal Credit Reform Act of 1987" and the Committee's timely hearings on the need for reform of federal credit accounting.

Since 1984, along with Representative Bill Gradison, I have argued that the current budgetary treatment of federal credit programs--loans and guarantees--is seriously defective and misleading. We have argued that what should be in the federal budget is the true cost of these programs--that is, the subsidies they convey. And we have shown that one way to bring these true costs into the budget is for the federal government to sell new loans to private investors as they are made, and to reinsure new federal guarantees with private insurers.

I am delighted that the bills we introduced, S.2500 in 1984, S.502 in 1985, and S.2142 in 1986, are so clearly reflected in the Administration's credit reform proposal. It has been a long and lonely fight--especially until Senator Heinz joined the reform forces last year with his credit reform bill. We are delighted to have the Administration take up the cudgels for this long-overdue reform.

The Administration's proposal blends the best elements of the Tribble-Gradison and Heinz bills in a constructive way. I believe "the Federal Credit Reform Act of 1987" is a very positive proposal, and I fully support it. It addresses and answers the major shortcomings of current budget accounting for credit programs. It brings the true costs of loan and guarantee programs into the budget, and attributes them to the responsible agencies.

I hope that this Congress will pass the Administration bill, or something very close to it, and I intend to do everything I can as a member of the Government Affairs Committee to make it law.



Mortgage Bankers Association of America

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Burton C. Wood
Senior Staff Vice President
and Legislative Counsel
202-861-6507

April 24, 1987

The Honorable Lawton Chiles
Chairman
Committee on the Budget
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

On March 18, Senator John Heinz introduced S 745, the "Federal Credit Reform Act of 1987", which establishes dramatic new Federal credit program restrictions. The alleged purpose of this legislation is to consolidate management of all Federal credit and direct loan programs within the U.S. Treasury, to deauthorize the Federal Financing Bank (FFB) functions, and to impose controls that will limit the role of Federal credit programs. The intent of this legislation is clear--quantification of the "implicit subsidy" or "grant-equivalent" for Federal guaranteed and direct loan programs. These are simply tools for sharply restricting use of Federal credit programs.

A Federal Credit Program Revolving Fund (the Fund) would take on FFB's current role as the "traffic cop" for funding federally backed direct and guaranteed loans, as well as assuming additional "management" functions, which include measuring program "subsidy" costs, collecting credit program data, and improving debt collection practices. The Fund would assess fees for each program, would establish and maintain reserves for payment of claims and losses, and would sell or reinsure loans and guaranties where Treasury determines it appropriate. Credit program policies and eligibility guidelines would remain within the jurisdiction of agencies currently operating credit budget programs. Finally, the proposal provides that appropriations acts would not only have to establish program limits for direct lending activities and credit ceilings for credit programs, but would also have to contain a line item "appropriating" the "grant-equivalent" estimate attached to each program. This fee would actually be paid into the Fund and recorded in the budget account of the originating agency.

The bill covers all loans, credit guaranty, and direct loan programs of Federal agencies and entities partially or wholly owned by the government. This would cover mortgage credit activities of the Veterans Administration, the Federal Housing Administration, and the Government National Mortgage Association. The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation do not appear to fall within the purview of this proposal. The Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation will not be subject to program limitations or appropriations requirements, but an estimate of the implicit subsidy will be included in the annual budget.

The proposal would raise dramatically the costs of the housing credit programs to homebuyers and substantially increase the "profits" these programs bring to the government. In its FY 1987 budget request, the Office of Management and Budget has already estimated the present value of these "subsidies" at 1.2 percent for FHA, 1.9 percent for GNMA, and 6.3 percent for VA. As stated in the Administration's budget, these figures measure "the value of the subsidy to the borrower, not the cost of the subsidy to the Government." (Source: Special Analyses: Budget of the United States Government," Page F-37.)

MBA believes, that the mechanisms proposed in S 745 go far beyond any reasonable concept of how to account for the costs of Federal credit programs. This proposal, in essence, allows the Executive Branch to assess user taxes on credit programs that would far exceed the governments' actual cost of providing credit backing and would result in taxing homebuyers for any benefit (regardless of whether there is any financial cost to the government) that the government program currently provides. The fundamental question here is what purpose will government credit backing possibly serve if any "benefit" from the program is simultaneously taxed away.

The original Congressional intent behind creation of the FHA, VA, and GNMA programs was to foster homeownership opportunities by enhancing the affordability and availability of mortgage credit via the Federal guaranty. To allow the U.S. Treasury to collect fees from borrowers that recapture the benefit derived from the guaranty undoes the very purpose of these programs.

The real benefit enjoyed under the housing credit programs is the capital market efficiency of the GNMA security, and the standardization offered by the underlying FHA and VA loan instruments, along with the unique terms of those instruments. The non-subsidized FHA mortgage insurance program has created an atmosphere encouraging a continued source of private mortgage credit for low-downpayment, fixed-rate loans to homebuyers. The GNMA-MBS program ensures ready placement in the secondary market for FHA and VA loans. In effect, the existence of the GNMA-MBS program allows the individual consumer the same access to the credit markets as large corporate borrowers and the government.

MBA believes that the Administration's "Credit Reform" proposal is a wolf in sheep's clothing. Under the disguise of credit management, this proposal will require borrowers to pay a user tax for the "grant equivalent" attached by the Fund to a particular Federal credit program. MBA is extremely concerned that

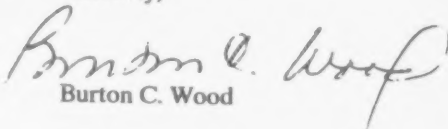
this proposal abdicates control over congressionally authorized credit programs to the Executive Branch. The Fund and the operative program agencies will have the power to estimate the grant-equivalent subsidy. Congressional authority will be reduced to appropriating the mandated grant equivalent. Even more alarming, it appears that the proposal gives the Fund the authority to reestimate the grant-equivalent when economic features change (interest rates move up or down, the supply of available credit contracts or expands, etc.). If such a reestimate is made, the proposal appears to allow the Fund unilaterally to assess the reestimated fee and when the appropriated line item is exhausted before the program limitation is reached, then the program would be shut down unless and until supplemental appropriations were approved.

Housing programs (FHA, VA, and GNMA) represented 86 percent of the guaranteed loan commitments in 1986. The FHA and GNMA programs, as well as a number of miscellaneous, non-housing, guaranteed loan programs fall under the jurisdiction of the Banking Committee. Because the new approach would fundamentally alter the character and direction of these programs, it is essential that all of the Committees of jurisdiction have a say in the progress of potential legislation. Therefore, MBA strongly believes that joint referral to the Banking Committee and the Veterans Administration Committee as well as Budget or Government Operations Committees would be appropriate.

MBA urges Congress in its review of this proposal to give serious consideration to the policy implications embodied in S 745, as well as the technical difficulties represented by the measure.

MBA would like to request that this statement be included as part of the hearing record on the hearings held by the Senate Budget Committee on March 4. We would be happy to furnish any additional needed information.

Sincerely,


Burton C. Wood

**Statement of the Mortgage Insurance Companies of America
for the Senate Budget Committee's Hearings
on Federal Credit Program Budgeting.**

The Mortgage Insurance Companies of America (MICA)* appreciates the opportunity to provide comments on the management of Federal credit programs. Determining a clear picture of the social and economic cost of loan guarantees and their effect on the allocation of resources is essential to public policy that will foster competitive and efficient markets.

The major focus of the Senate Budget Committee is to measure the level of assistance rather than to address policy questions of program performance or who in our society should receive government assistance. An objective is to uncover the direct and indirect costs that result from government support of an activity through the credit markets. The use of government credit enhancements allows the shifting of various operating risks by some private firms to the government and this involves very real and measurable costs including the restricting of economic opportunities of firms that compete with the government.

*MICA consists of the thirteen domestic private mortgage insurance companies which represent the active firms that help loan originators and investors make funds available to homebuyers by protecting these institutions from a major portion of the risk of default. The current MICA officers are President, C. Earl Corkett of PMI, San Francisco; Vice President, William Lacy of MGIC, Milwaukee, WI; Treasurer, J. Edward Carlton of Integon Mortgage Guaranty Insurance Co., Winston Salem, NC; and Secretary Fred Reichelt of Verex Assurance, Inc., Madison, WI. MICA also has private mortgage insurance companies members in Canada and Australia.

The largest credit program is the mortgage insurance program of the Federal Housing Administration. MICA is in a unique position to address the issue of how much this program costs because our industry is the private sector alternative that competes with Section 203(b) of that program. Our experience from direct competition with the FHA makes us believe it is possible for the Budget Committee to develop a method to measure the costs of government loan guarantees.*

In sum, the measurement of benefit costs of FHA guarantees involves at least three factors; a cost based upon the direct underwriting income or loss from the program; a cost based upon the catastrophic risk from the possibility of seriously adverse economic cycles; and a cost that relates to the supply and demand effects on the credit markets when guarantees are used to allocate resources.

Policy confusion exists as to the budget impact of FHA insured loans because the underwriting aspects of the program have run on a fee basis which has generated a surplus. Proponents of the program claim this surplus allows the FHA to be free of any subsidy. This is inaccurate and misleading.

Measuring FHA's cost without taking into consideration contingent risk that can result from a seriously adverse or catastrophic economy that has an analogy with the deposit insurance

*MICA would be happy to provide the Committee more detailed historical or statistical background about the private industry's competition with the FHA. Respecting the Committee's desire for concise statements, we will reserve this information for any supplemental request the Committee may deem helpful.

of the FSLIC. That government agency clearly operated with a surplus until a catastrophic level of loss resulted from the massive restructuring in the savings and loan industry. The Congress is now aware that the contingent catastrophic risk was clearly underpriced for some institutions and Congress may have to directly fund these liabilities.

The value of the FHA guaranty to the lender must be measured not only in terms of lower default risk that includes catastrophic risk but in terms of the increased marketability that the government guaranty provides the loan. As the mortgage markets have become more integrated with the general capital markets, it has led to a wider separation between mortgage originators and the suppliers of mortgage funds (investors). The economics of the mortgage lending business have changed. This change has created significant economic incentive for some private firms to increase demand for federal guarantees that will assume some of their operating risks.

When the federal guaranty on mortgage assets is provided below an established private market cost, it allows greater potential for profit to be distributed among firms originating, selling, and investing in loans. The private guarantees act as enhancements to the credit and guarantees with government backing establishing the maximum liquidity and the best price for insured assets. Clearly the advantages that FHA insured loans have over privately insured loans such as access to GNMA, higher profits for loan originators and seller/services, lower borrowers loan rates resulting from lower

yields on government securities, deeper collateral protection and more liberal underwriting, have a definite price. Thus, the pricing of the guarantee must value not only the loss protection but the entire enhancement value that increases the loan's marketability. Evidence from the competition between private and government credit enhancement demonstrates how the market will price federal credit support.

MICA believes that the solution the Committee seeks for the pricing of federal credit guarantees must be based upon a value that a competitive private firm would charge for providing comparable coverages. The principles that could be used as a method for performing a valid pricing of government services (such as loan guarantees) has already been developed by the Congress in at least one instance.

When Congress passed the Monetary Control Act of 1980 it required that the Federal Reserve Banks establish fees for its priced services.[12 USC 248(a)] These fees would, over the long run, have to cover the full costs of providing services and include the cost of a float as well as an allocation of imputed costs which takes into account the taxes that would have been paid and the return on capital that would have been provided had the services been furnished by a private firm. In effect the Federal Reserve uses a market adjustment factor in pricing their check clearing, wire transfer and other priced services. The Federal Reserve reports to Congress on its pricing experience.

A similar method could be implemented by the FHA or other Federal guarantor of credit. To illustrate a pricing exercise for the FHA we have set forth below some pricing assumptions based upon the experience of typical private insurer evaluating a 95 percent FHA loan:

Loan-to-value	95%		
Instrument	Fixed		
Coverage	100%		
Salvage Value	65%		
Half Life	12 Yrs.		
Claim Incidence	6.2/100		
Expenses/Ceding Commission	10%		
Risk/Capital Ratio	20:1	25:1	
@ 20% expense ratio	585	20%	515
@ 30% expense ratio	660	30%	590

This pricing exercise shows a private firm operating at the most efficient level with a 20 percent expense ratio would have to charge 585 basis points for such a FHA loan. Based upon the private cost to cover the default risk there is an adjustment factor of 205 basis points that would need to be added to the FHA's current premium of 380 basis points.

A complexity in applying this model would result because the FHA does not differentiate rates as private firms do based upon the risk characteristics of loans such as borrower downpayment. The single rate policy was appropriate since FHA was intended from its inception to be primarily targeted to the lower income underserved market. In recent years, however, FHA has been used by higher income, higher risk borrowers including investors. The concept of cross subsidization of high risk borrowers by low risk FHA borrowers can no longer be described as conforming to any mandated social policy according to borrower income.

This fact is important for the Budget Committee because it suggests that in pricing a government loan guaranty, the program being evaluated should be broken down according to a realistic market based risk matrix in order to price as private firms do with a greater differentiation of risk. This is essential in order to truly identify the subsidy involved. For example, a private firm would price risk on a loan with a 3 percent downpayment differently than a loan where the borrower has made a downpayment of 20 percent or more.

In the case of a large downpayment FHA loan, the borrower may not, in fact, be receiving any subsidy from the government to cover the cost of the default coverage. That borrowers, however, did choose the government insured loan over the lower premium privately insured loan. This demonstrates the existence of other government assistance that allows the lender to provide this borrower an inducement making the borrower willing to pay a default insurance premium that may be higher than if that borrower were to obtain a conventional loan.

Today the value that goes to the lender of enhanced marketability of a loan from the FHA guarantee is substantial. It allows the lender to possibly offer borrowers a lower interest rate, more liberal underwriting requirements, loan assumability or other inducements and still make a profit that is at least as good as that which the lender would receive from originating a conventional

loan. If this were not the case private lenders would not aggressively participate in the government program as the facts demonstrate. The major point, however, is that the enhanced marketability must be priced in evaluating the cost of the guarantee.

One may question what does this enhanced marketability of FHA loans cost the government? The answer can be found in the effect it has in the credit markets. It is a fact from observing government involvement in the credit markets that providing assistance to help a certain class of borrowers does not increase the total supply of credit. Thus, according to the rules of supply and demand, when the government helps some borrowers, the price of credit for other borrowers in the market must increase. The price will increase in an amount necessary to reduce the demand for credit by these other borrowers in an amount equal to the demand increase that occurred from the borrowers in the targeted sector. This is not to say that such allocation is an incorrect policy but simply that it has costs that can be determined.

In summary, there are economic costs from the effects of over reliance upon federal credit. This policy issue can only be appropriately addressed by having government assistance accurately reflect all costs as well as the value of benefits that translate into lost opportunity costs for private sector firms. Congress must be aware that when private firms cannot compete with the government it results in less competitive and less efficient markets. •
Therefore, we believe the Budget Committee should, at a minimum,

insist that all government entities such as the FHA - which offer guarantees and directly compete with private firms, provide a pricing estimate of their services based on private competitors costs for comparable coverages. These entities should present the Budget Committee with a market adjustment factor in a manner similiar to that illustrated above.

We hope these comments are helpful and would be happy to provide the Committee additional information.

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WRITTEN COMMITTEE QUESTIONS TO MR. BLUM AND THE RESPONSES

RESPONSE OF JAMES BLUM TO QUESTIONS SUBMITTED
FOR THE HEARING RECORD,
MARCH 4, 1987
SENATE BUDGET COMMITTEE

I. Subsidy Values: Benefit to Borrower or Cost to Government?

Questions:

The Administration proposes to measure subsidy values in terms of the cost of obtaining comparable credit from a private source.

1. Won't the result be subsidy estimates that are higher than the government's cost?
2. Shouldn't the federal budget measure the cost to the government?

Answer:

Yes, the federal budget should attempt to measure cost to the government, but it is extremely doubtful that the government's cost of providing credit is lower than private costs in any economically or socially meaningful sense. Some analysts have claimed that the government has lower costs because it does not pay federal taxes and because it has a lower cost of money (both debt and equity).

To insist that government hold loans because it is exempt from federal taxation is a false economy. Government receives these higher private costs. Further, the higher cost of money for private firms is irrelevant to the market pricing of financial assets. Market prices for loans will reflect the expected streams of income from these loans discounted at a risk-adjusted rate. Those who believe that investors' cost of money determines the price investors pay for loans must explain how investors can afford to purchase billions in riskless U.S. Treasury securities which--by definition--yield less than the investors' cost of money.

II. Loan Sales and Reinsurance

Question:

The Administration proposes to sell loans and "reinsure" loan guarantees.

1. Won't this increase the cost of federal loan programs for the government and the taxpayers?

Answer:

We have no basis for assuming this result. See answer to previous question.

III. Credit Reform and the FY 88 Budget

Question:

The Administration proposes to incorporate credit reform--including accounting changes, loan sales, and reinsurance--in the FY 1988 budget.

1. Is this realistic?

Answer:

The Administration's plan for credit reform is fairly limited in scope inasmuch as it involves only the creation of a central revolving fund and a relatively small volume of loan sales and reinsurance (\$1.5 billion in loan sale receipts and \$500 million in reinsurance premiums for 1988). The final proposal may arrive too late, however, to be incorporated fully in the Congressional budget process.

IV. How Would Credit Reform Affect Program Operations?

Questions:

I understand that there is already some opposition to the President's proposal for credit reform. Some see it as nothing more than a backdoor way to get the federal government out of the credit business.

1. How would you respond to this charge?
2. Would credit reform change the way federal loan programs operate?

Answer:

One objective of credit reform is to improve program operations without reducing program benefits. More complete documentation and efficient loan servicing are intended to reduce the frequency of default and the loss to government and borrowers in the event of foreclosure. Another objective is to improve the quality of management information about the performance of credit programs. Superior information should increase the effectiveness of oversight by the Congress and the Executive Branch.

Some observers fear that loan sales would change the terms and conditions of the loan agreement--that by selling loans, terms would revert to those offered by private lenders. If this were to happen, it would undermine the original purpose of the loan.

This fear is baseless. The terms of the loan contract cannot be changed by a loan sale. If the borrower has agreed to pay interest of 5 percent, for example, this will be unaffected by the sale. Additional forbearance and leniency can be written into loan contracts and could not be changed by the purchaser of the loan. These concessional, noncommercial terms will be reflected in the price at which the sale takes place. But the sale will not change the terms.

V. Counting Loan Sales as Deficit Reduction

Question:

Two weeks ago, the Budget Committee received testimony on loan asset sales from two distinguished economists, Alan Greenspan and Martin Feldstein. They stated in no uncertain terms that receipts generated by the sale of existing loans should not be treated as a reduction in the deficit.

1. Does the same logic apply to the sale of new loans as part of a credit reform initiative?

Answer:

Yes. Neither the cash outflow of new disbursements nor the cash inflow from sales should be included in budget outlays. The CBO proposal would immunize the deficit from distortions caused by credit cash flows by removing those cash flows from budget outlays and the deficit.

VI. Which Loans Should Not Be Sold?

Question:

There are plenty of arguments for selling loans to the public. Foremost among them is the fact that it will force the federal government to clean up its servicing and management practices.

I can't help but be concerned, though, that some of this efficiency gain will come at the expense of borrowers we might otherwise want to help out of a jam.

1. Are there certain kinds of loans that should be excluded from sale for that reason?

Answer:

In all credit programs, the intent is to provide assistance by making credit available on below-market terms. Concessionary terms, therefore, do not provide a basis for exclusion from sale. The Administration proposes to exclude "loans" that are more closely related to grants than loans such as credits which are routinely forgiven (foreign military sales). They also propose to exclude commodity price support "loans" which are in the nature of a commodity purchase. Loans to foreign national governments are also to be excluded on foreign policy grounds. Energy conservation loans from the Tennessee Valley Authority and loans from the Bureau of Indian Affairs to Indian tribes would be excluded from sale because the Administration believes that such sales would "interfere with program operations."

VII. Loan Sales vs. Program Cuts

Questions:

One reason that people give for selling loans is that the government never should have made many of them in the first place.

1. Is selling loans or purchasing reinsurance any substitute for the savings that would result from cutting program levels?
2. Is there any financial advantage to the government in selling its loans or reinsuring guarantees?

Answer:

That government should sell loans because it "never should have made many of them in the first place" is not a sensible argument. Once a subsidized loan is made, a subsidy is conveyed and there is no way to reverse the transaction. If the loan is sold, the contract terms remain in place and the subsidy to the original borrower is unaffected. Loan sales are irrelevant to the policy issue of whether government should engage in a particular credit assistance program.

The government may obtain some financial advantage from the sale of loans and reinsurance of guarantees if private firms can perform loan service and collection more efficiently than the government; if private underwriters are more efficient at managing risks; or if sales improve the efficiency of agency credit operations. The gains, if any, have to come from efficiency improvements, not the cash flow proceeds or premiums. To the extent that efficiency gains are realized, a larger amount of assistance could be provided to beneficiaries for any given level of cost to the government.

WRITTEN COMMITTEE QUESTIONS TO MR. WRIGHT AND THE RESPONSES

Question. What are the implications of the Administration's credit reform proposal on FHA borrowers or student loan borrowers? Will this proposal make these loans more expensive?

Answer. The credit reform proposal will not make these programs more expensive. Nothing in credit reform alters the credit programs (including the terms and conditions of direct and guaranteed loans) that the Congress has enacted or changes the existing authority of agencies to operate credit programs. Instead, the credit reform proposal is intended to address the current shortcomings of budget accounting for credit programs. It would change the present system of scorekeeping for credit programs and give Congress and the Administration better information to evaluate the costs and benefits of Federal credit programs.

Question. How can we address the issue of forbearance for ailing farmers as we deal with the issue of Federal credit reform? Or do we simply say tough luck to those farmers who face foreclosure?

Answer. Credit reform does not alter the existing legal or contractual rights of borrowers. If the loans are sold, new lenders will have an incentive not to foreclose on the loans they purchase. However, if the new lenders do not exercise the desired amount of forbearance, the government can extend new loans to ailing farmers. The same situation would exist even if the loans are not sold. The Government can only exercise forbearance to the extent forbearance was counted as part of the subsidy; then no new appropriation is required. If forbearance was not included in the subsidy calculation, then Congress can enact forbearance provisions; appropriations would have to be available to cover the additional subsidy costs. The credit reform

proposal is only intended to score credit programs properly. Decisions on timing and the level of forbearance are outside the scope of credit reform.

Question. Won't the use of "benefit to borrower" subsidy calculations results in estimates that are higher than the Government's cost? Shouldn't the Federal budget measure the cost to the Government?

Answer. The credit reform proposal has several major objectives. It seeks to measure the costs of Federal direct loan guarantees in ways that are economically valid for making program decisions. It seeks to eliminate biases caused by budget scorekeeping in the choice between different forms of credit assistance. It also seeks to minimize the role the Government plays in financial markets, while simultaneously achieving the program objectives set by law. All of these objectives are compatible with the "grant-equivalent" or "benefit to borrower" approach to credit subsidy scorekeeping, but none is compatible with the "cash outlay" or "cost to the Government" approach. In large measure this is so because the cash outlay approach significantly understates the true cost to the Government. We can see how this occurs by comparing how the two sets of subsidy estimates are derived.

Under the grant-equivalent approach, the value of the loan is what the market would pay for it. In concept the subsidy is simply a residual—the face value of the loan less the market value of the loan. Under this approach, the market provides a test of the subsidy estimates, and the results of this testing are fed back into the subsidy calculations. These market assessments include the full cost of loans: interest, risk, cost of servicing, etc., so as to place subsidized loans on an even basis with privately originated loans.

In contrast, the cash outlay approach understates not only the full market cost, but also the cost to the Government. This approach only takes into account the direct interest cost of Federal borrowing. Treasury securities are risk-free investments. In contrast, all Federal lending involves a risk, and the riskier the loan, the greater the subsidy hidden by the cash outlay approach.

Finally, the Congressional Budget Office agrees with the Office of Management and Budget on the appropriateness of using a grant-equivalent approach to estimating the subsidy—that is, the subsidy cost should be defined as the additional payments a borrower would have to make for a fully private, rather than a Government-assisted, loan.

Question. Won't the Administration's proposal to sell loans and "reinsure" loan guarantees increase the cost of Federal loan programs for the Government and the taxpayers? That is, won't the sale or reinsurance of loans require the Government to pay certain costs that it otherwise would not bear?

Answer. The provisions of the credit reform proposal that require selling direct loans and reinsuring loan guarantees are needed to provide the most accurate measure of the subsidies inherent in Federal credit programs. The credit reform proposal measures the cost of Federal credit programs—it does not increase these costs.

The notion that the sale or reinsurance of loans would require the Government to pay certain costs that it otherwise would not bear reflects an incorrect perception of how Federal credit transactions impact the domestic credit market. Federal credit activities are not separate from private credit transactions—there is only one credit market which connects "surplus spending units" with "deficit spending units." Accordingly, there is a price to pay whenever the Government intervenes in the credit market and current budgetary scorekeeping does not capture the full cost of this intervention. The grant equivalent method of measuring the subsidy inherent in Federal credit programs does capture all costs—it takes into account tax advantages as well as financing, credit allocation, and administrative costs. In turn, direct loan sales and the reinsurance of loan guarantees are consistent with the grant equivalent method.

Question. Is it realistic to expect that these reforms can be put in place for the FY 1988 Budget and Appropriations cycle?

Answer. We believe it is realistic to put these reforms in place in FY 1988. The Administration has spent months preparing the staff at the agencies and Treasury to begin implementation on October 1, 1987. We have estimated subsidies using the grant-equivalent method for years. Moreover, the Administration's pilot loan asset sales program has given us valuable experience that will be very helpful in selling loan assets as part of credit reform. Although we do not have first hand experience with reinsurance of loan guarantees, we are phasing in reinsurance slowly while we gain that experience.

Question. Isn't all this talk about credit reform just a backdoor way to reduce or eliminate credit programs passed by Congress? Also, would credit reform change the way Federal loan programs operate?

Answer. There is nothing in the credit reform proposal that alters the credit programs that the Congress has enacted or changes the authority of agencies to operate credit programs. Credit reform is not a backdoor way to reduce or eliminate the credit programs passed by Congress. Current Congressional authority to establish the level of assistance provided to borrowers or alter the terms and conditions under which credit programs are provided (the terms and conditions set the level of subsidy provided through Federal credit programs) is not changed. Only the scorekeeping method for measuring the cost of credit would change.

Question. When Alan Greenspan and Martin Feldstein testified before the Senate Budget Committee they stated that receipts generated by the sale of existing loans should not be treated as a reduction in the deficit. Does the same logic apply to the sale of new loans as part of a credit reform initiative?

Answer. Dr. Greenspan and Dr. Feldstein both supported the Administration's credit reform proposal and did not oppose the sale of existing loan assets but felt the receipts from the sale of loans made in a previous year should not be scored against the deficit of the present year. Dr. Greenspan cautioned against applying the sales proceeds from loan asset sales to reducing the deficit because this scoring diverts attention from making long-term deficit reductions by adjusting receipts and expenditures. Dr. Feldstein opposed using the proceeds from selling existing loan assets to meet GRH targets because asset sales do not reduce the real federal deficit—they do not diminish the government's involvement in U.S. credit markets and would not increase the national saving rate.

In contrast to the position taken by Dr. Greenspan and Dr. Feldstein, budget accounting policy has been for all offsetting collections to be scored against the deficit. Scoring the proceeds from existing loan asset sales against the deficit is consistent with this policy.

Still, despite the difference of opinion over the sale of existing loan assets, clearly the logic behind the reasons why Dr. Greenspan and Dr. Feldstein do not want to apply the proceeds from loan asset sales to the deficit does not apply to loan sales under the credit reform proposal. Under credit reform the sale of loan assets would occur shortly after the loan is made which is different from selling loans made in previous years.

In addition, keeping the proceeds from loan asset sales separate from the deficit is equivalent to the CBO proposal of attributing the subsidy portion of the loan to the agencies originating the transaction while keeping the unsubsidized piece "below the line." Although this idea has a great deal of conceptual merit, the proposal contains the potential for abuse because it would create the temptation to underestimate subsidies. It does so because there would be an advantage for an agency to increase the "below the line" amount which would decrease the amount of subsidy charged to the agency. This is an outcome we should avoid.

Question. Are there certain kinds of loans that should be excluded from sale—especially loans to borrowers that we might otherwise want to help out of a jam?

Answer. Not all direct loan programs will be included in the credit reform proposal. Those excluded are the CCC commodity loan program, which is more of a commodity purchase program than a credit program, and direct loans that result from defaulted guaranteed loans, which are more of an extension of the loan collection process than they are new loans. In addition, several programs will be included in the credit reform proposal but will be exempt from requirements to sell loan assets. For example, international loans with foreign policy ramifications and loans made by financial regulators will not be required to be sold.

The actual decision about which loans to sell and which to hold would be left to the discretion of the Secretary of the Treasury or his representatives, who are the officials with ultimate responsibility for operating the fund, subject to normal Office of Management and Budget review.

Question. Is selling loans or purchasing reinsurance any substitute for the savings that would result from cutting program levels? Is there any financial advantage to the Government in selling its loans or reinsuring guarantees?

Answer. See answers to above questions.

